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SECONDARY MORTGAGE MARKET

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

PROPOSED CHANGES IN THE CHARTER OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION, (FANNIE MAE), FEDERAL HOME LOAN MORTGAGE CORPORATION (FREDDIE MAC), THAT WILL ENCOURAGE A MORE BROADLY BASED AND RESILIENT HOUSING FINANCE SYSTEM AND PROVIDE A STABLE AND GROWING SUPPLY OF HOUSING CREDIT AT REASONABLE COST, WITH MINIMAL FEDERAL INVOLVEMENT

MAY 5, 1983

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SECONDARY MORTGAGE MARKET

THURSDAY, MAY 5, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met, at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator John Tower (chairman of the subcommittee) presiding.

Present: Senators Tower, Heinz, Riegle, Lautenberg, and Proxmire.

OPENING STATEMENT OF SENATOR TOWER

Senator TOWER. Would the committee come to order for a little preliminary business before we start our hearing.

Three weeks ago during the consideration of the Proxmire cat amendment, I personally thanked Senator Proxmire and said that I would have a few ready for adoption. I would like to announce that they are currently ready for adoption, four beautiful tabbies. They wanted to be here personally to thank Senator Proxmire and if anybody would provide a good home, just call Mandy at 224-2934. I emphasize, however, they are a product of social irresponsibility. [Laughter.]

The committee will come to order.

In calling this hearing today the committee is seeking ways to encourage a more broadly based and resilient housing finance system. The President's Commission on Housing perceived that the goals of the Federal Government should be "the creation of a system that will provide a stable and growing supply of housing credit, at reasonable cost, with minimal Federal involvement." It is the hope of this committee to support a properly functioning market in which funds can flow freely to meet demands, not unduly influenced by any one sector of the industry or any one organization, but subject to healthy competition which creates the lowest price and fairest terms to the home buyer.

This morning we will discuss a number of proposals for changes in the charter of Fannie Mae and Freddie Mac as they are commonly known. Our witnesses will help the committee evaluate the proposals in light of the increased demand for the services of the secondary market stemming from major changes in the financial community, the need to facilitate the housing recovery, and a desire to foster the growing, private participation in the secondary mortgage market.

In addition, the committee will continue its exploration of the need for mortgage default assistance and appropriate changes to the default assistance provision now in the committee's HUD authorization bill.

We have several witnesses this morning. We are delighted to welcome as our first witness this morning the distinguished junior Senator from Pennsylvania, Senator Specter. Senator Specter, you may submit a statement to be published in its entirety in the record and summarize it or you may present it in its entirety, and I have received that, so you may proceed.

Senator **Specter**. Thank you, Mr. Chairman.

Senator **Heinz**. Mr. Chairman, before you start, may I just welcome my colleague from Pennsylvania?

Senator **Tower**. You certainly may.

STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Mr. Chairman, I thank you for yielding.

I want to welcome my colleague from Pennsylvania who has worked so hard on a variety of problems that really affect so many of our constituents, not only in Pennsylvania where we have hundreds of thousands of people—some 700,000 of them—who are in dire straits, many of whom stand at risk with respect to losing the homes they have worked a lifetime to try and save for, many of whom are afflicted, as he and I well know, with real problems in obtaining health care having lost not only their jobs but even their unemployment compensation.

If I may say, we will be later today, in addition to hearing from my colleague, be hearing from one Pittsburgh organization, a very fine organization called Action Housing, a community-based organization which has been setting a national example on how creative cooperation between public citizens and the private sector can kind of reach out to the kind of distressed homeowners we're talking about, and we will also be hearing from some financial institutions, including the Dollar Savings Bank, also in Pittsburgh, and my understanding is that they strongly believe that the kind of initiative that we have in the housing bill is not only workable but enactable, practical, and responsible.

I just briefly want to commend my friend and colleague from Pennsylvania for his interest in this matter and I'm not going to mention Midland, Pa., because I suspect he may mention it in his statement. Thank you, Mr. Chairman.

Senator **Tower**. Let me yield to Senator Riegle for any statement he has.

STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. Thank you, Mr. Chairman. I have just a brief comment.

We're taking up several important issues here today including default assistance, as has been said, and the issue of how to maintain a strong secondary mortgage market in the United States. We have a number of key witnesses to hear today and I'm delighted that we're going to start with the Senator from Pennsylvania and the issue that he's come to address.

Senator **Tower**. Senator Proxmire.

Senator **Proxmire**. Mr. Chairman, I just want to tell the members of the panel because they came in late that they missed the high water mark, in my judgment, of the year so far. The chairman of this subcommittee brought in four of the most adorable kittens you've ever seen, proving that we have a chairman who isn't "kitting" around.

Senator **Tower**. As long as I don't tomcat around.

Senator **Lautenberg**. This is not one of my pet subjects. [Laughter.]

Senator **Tower**. Senator Specter, I apologize for the selected verse. We are delighted to have you this morning, so you may proceed.

STATEMENT OF ARLEN SPECTER, U.S. SENATOR, FROM THE STATE OF PENNSYLVANIA

Senator **Specter**. Mr. Chairman, I would be delighted to refer to any psychiatrist in the room who may wish to analyze the Freudian implications of these last series of remarks.

I thank the distinguished chairman and I thank the subcommittee for holding this hearing on these important subjects and I do have a statement which I ask to be included in the record and I shall briefly summarize it.

It is on the subject of default assistance. There is an enormous problem in this country illustrated by the problems in the Commonwealth of Pennsylvania which Senator Heinz has already alluded to and I shall amplify concerning the difficulties of mortgage foreclosures.

Our State as the State represented by Senator Heinz and myself has suffered very extensively from long-term chronic unemployment in the range of 13.2 to 13.6 percent, and even when the national average declined somewhat Pennsylvania's unemployment remains high, as does the unemployment remain high in Michigan, Ohio, and New Jersey and plenty of other States.

As a result of this chronic unemployment, the unemployed have had a series of problems and near the top of the list is the difficulty on mortgage foreclosures, exceeded perhaps only by the difficulty of lapse of health insurance, and I thank my colleague, Senator Heinz, for the very generous introductory remarks and would turn to the incident that he referred to when he and I traveled to Midland, Pa., on March 5 of this year to hold a town meeting open house to hear the citizens of that community, which has been especially hard hit because Crucible Steel located there closed, throwing 4,500 people out of work in one fell swoop and causing as severe a problem as any small community can sustain.

The problems which they brought to us were numerous and at the top of the list were the problems of health insurance which had lapsed for the unemployed, the problem of mortgage foreclosure, and the problems of high fuel bills. We heard a great deal about the problems of mortgage foreclosure.

Pittsburgh, Pa., was the site where national attention was first focused on this issue when the sheriff there refused to execute court orders for foreclosures and took upon himself to simply disregard those orders because unemployment was so high he thought their execution would be inappropriate.

That, in turn, led the Court of Common Pleas to suspend mortgage foreclosure actions illustrative of the seriousness of the problem, an executive official like a sheriff would deem it appropriate not to carry out a court order and then the court itself would suspend court orders although all the legal prerequisites had been fulfilled for execution on mortgage foreclosures.

A similar pattern later occurred in Philadelphia where the Court of Common Pleas similarly declared a moratorium on mortgage foreclosures.

It seems to me, Mr. Chairman and members of the committee, that the issue of default assistance is one of tremendous need across the country in terms of the tremendous unemployment which we have, in terms of a national policy which seeks to provide decent housing for every American and where the Congress has appropriated large sums of money to provide such decent housing, that there would be special attention to a narrow and limited problem of trying to help people in dire financial straits to save their houses. These are people who have worked a lifetime, who have made investments, who have bought houses and paid mortgages and then suddenly find themselves in a recession in terrible problems and need something to tide them over for a relatively brief period of time.

Now if as a Congress, if as a nation, we are going to provide housing for the needy as we do, certainly what group would be more deserving of attention than those who find themselves in sudden economic straits?

I would further suggest to the subcommittee that this kind of mortgage assistance should cost the Federal Government in the long run absolutely nothing or very little because it is possible to structure such financial assistance as part of the lien of the mortgage. I think in virtually all of these properties there is substantial equity because they have been bought with a downpayment, there have been mortgage payments made, so that an advance by Federal assistance could easily take the position of a second lien to be guaranteed on repayment in the event of that ultimately the homeowner did not pay the Federal Government, did not pay his mortgage. Now it may be that in some isolated cases there would be insufficient equity to protect the position of the first mortgagee or the position of such a governmental advance, but I would think that would be minimal indeed.

I introduced a bill on this subject, S. 313, on February 1, and legislation has been introduced by my colleague, Senator Heinz, and by my colleague from Michigan, Senator Riegle, and this is a subject which the Northeast Midwest Coalition has been concerned about, cochaired by Senator Riegle and myself during the course of the 97th Congress, and I know that the committee has acted to include this kind of assistance subject to this hearing on May 5 and I certainly commend the full Banking Committee for taking this action and offer my support to the action which has been taken, and this hearing I think will provide a strong evidentiary basis for retaining it and would say further that I hope we will take the action in the current budget resolution which is pending—and I have already written a "Dear Colleague" letter on the subject and have discussed the matter with Senator Heinz and Senator Riegle and others to see that we have the appropriate funding to carry forward this emergency assistance.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR ARLEN SPECTER
ON
EMERGENCY MORTGAGE RELIEF

I am pleased to have this opportunity to testify before the Banking Subcommittee on Housing and Urban Affairs. I wish to commend Chairman Tower for scheduling hearings on mortgage relief for the unemployed. Today's discussion can help to emphasize the urgency of the situation and the need for an immediate and adequate legislative response.

The mortgage foreclosure problem first attracted national attention when two Pittsburgh-area county officials invoked a temporary moratorium on sheriff's sales of unemployed workers' homes. Today it is widely known that some type of federal involvement is necessary to halt the record-high number of foreclosures taking place nationally. Economic difficulties have threatened Americans' most cherished and valuable possession: their home. The Mortgage Bankers Association of America has estimated that more than 138,000 Americans are in immediate danger of losing their homes or farms. During 1982 there was a fifty-year high of 187,000 homes lost to foreclosure, and there is little evidence to suggest this figure will decline. In February, for example, more people fell behind in their mortgage payments than at any time in the past twenty years. Today the rate of mortgage delinquencies stands at 2.36 percent, or double the historic average as rated by the Federal Home Loan Bank Board.

As the recession continues to inflict financial distress on thousands of families, the need for homeowner protection from foreclosure becomes more critical. Recognizing the need to provide relief to unemployed workers faced with imminent foreclosure, I introduced S.313, the Emergency Mortgage Assistance Act, on February 1, 1983. The purpose of this bill is to prevent mortgage foreclosures, resulting from the temporary loss of employment, by offering assistance to defray mortgage expenses. Short-term aid, lasting up to 18 months, would be available to those residing in labor-surplus areas who are receiving or have exhausted unemployment benefits and are 60 days delinquent in making any mortgage payment. The program would be administered by the Secretary of Housing and Urban Development and financed through a fund established within HUD specifically for mortgage assistance. The Secretary would make payments to the mortgagee where the requisite delinquency occurred. These payments by HUD would constitute a lien against the residence, thus assuring the government of repayment as a secured creditor. Once the homeowner was reemployed, the amount of the special HUD loan would be repaid by a ten percent increase on the regular mortgage payment.

There is at the present time a temporary mortgage assistance program administered by HUD. Under existing law, the Secretary of HUD provides 18 months of assistance for HUD mortgages only, with an option of a contract for an additional 18 months. S.313 is similar to that existing program except that this bill would apply to all mortgages, whether FHA, VA, or conventional.

This legislation offers hope. For the unemployed enduring severe economic and personal hardship, the Emergency Mortgage Assistance Act provides the opportunity for these workers to retain their homes until economic conditions improve. The temporary financial assistance can be a long-term cost-saving measure because the federal government can avoid making costly outlays to fund new assisted housing structures necessary to shelter displaced families. To qualify for assistance, a region must have an unemployment rate in excess of the national average by more than one percentage point.

I would like to commend the Senate Banking Committee for including a mortgage foreclosure relief program in its housing authorization bill. I have examined the proposal and believe it represents a different but fair approach to this problem. The House of Representatives is also considering a measure to provide foreclosure relief. While I favor the Emergency Mortgage Relief Act above the other proposals, I am most interested in producing mortgage relief legislation which will provide short-term assistance as soon as possible.

A profile was recently developed of those from Western Pennsylvania who have been unable to meet their mortgage payments as a result of severe unemployment. The survey determined that the average homeowner threatened with foreclosure is between 25 and 45 years old with three to four dependents. The average principal amount represented by these mortgages is between $40,000 and $50,000 and has been held for between five and ten years. These homeowners did not have any prior default of their mortgage payments until losing their jobs during the present recession.

The profile reveals that it is the middle class most harshly affected by the ongoing recession. Western Pennsylvania, like many other regions throughout the country, has thousands of hardworking and dedicated workers who are searching for jobs. It is imperative that they do not lose their homes while looking for new employment. I thank the Committee for this opportunity to testify and urge my colleagues in the Senate to promptly enact mortgage relief legislation.

Senator **TOWER**. Thank you very much, Senator Specter.

Senator Riegle.

Senator **RIEGLE**. Let me just ask you this, Senator Specter. You make a very strong presentation which coincides with my experience in Michigan and in other parts of the country, particularly in those States that have been hard hit by unemployment. I am struck by the fact that this recession, its length, depth, and nature, is really extraordinary. It's quite different from other postwar recessions in terms of the degree to which basic industries have been affected, the degree to which layoffs have become long-term, and has gone way beyond what the normal unemployment benefit periods have anticipated in the past in the way of periods of cyclical unemployment. I have come to the judgment that this problem is extraordinary enough and different in kind that it requires us to respond in an extraordinary way to some of the problems that have been created, such as mortgage default.

In other words, we've got to match a very unusual national economic problem with a remedy that can enable us to deal with it.

Would it be your experience that the conditions you describe fit this kind of description? Do you see this as an extraordinary enough set of economic developments that it really requires us to take new steps that we have not felt impelled to take in this way before?

Senator **SPECTER**. Senator Riegle, I do. It is a different kind of consequences from recessions which we've had in the past at anytime and it has hit different areas of our Nation differently. States like yours and mine have different long-range impact because an upswing in the economy is not going to bring back the steel industry very fast and it may bring back the auto industry somewhat faster and it's very different from the impact in some of the other States.

It is difficult to structure a program which is going to move through with speed and be approved by the administration and signed by the President, and that's why my sense has been on this issue and also on the issue of health insurance to try to structure—to craft for a modest program limited, which is very precisely targeted to get it through in a hurry. I think speed is tremendously important and it is not the kind of an issue that we can debate at great length and have disagreements with the White House and we have been working on the health insurance field and I think we have to do the same here and really target.

I know you've traveled extensively in your State, as does Senator Heinz in Pennsylvania with his town meetings, and I was in western Pennsylvania in Erie and Meadeville and New Castle and Beaver Falls over the past weekend, and there is a lot of immediate pain and suffering requiring a very immediate response.

Senator **Riegle**. I was struck by your comment too that the local law enforcement officials, not just the sheriff but apparently the equivalent of the prosecutor's office, have decided now to have a moratorium on foreclosures because the extent of the problem is so widespread that the traditional officers have decided that they just don't want to go ahead with this sort of wholesale displacement of people. Is that right?

MORATORIUM ON FORECLOSURES

Senator **Specter**. Senator Riegle, that's exactly right, and it's a rather remarkable consequence because under the law when a court order issues for a foreclosure and a writ is handed to a sheriff he is obligated under the law to foreclose and to have a sheriff's sale and he refused to do so. Then they went back to the common police judge and he sustained the sheriff and declared the moratorium. That is really beyond his power as a judge to do so when all the legal requirements have been met. That happened in Pittsburgh. Then the Philadelphia Court of Common Pleas did the same thing.

Senator **Riegle**. This issue has not received national attention, at least not sufficient national attention. It is a very powerful illustration of the dimension of the problem. The families who are losing their homes have worked for years to save money to purchase a home. In many cases they are losing their only assets. They have become dispossessed, are out on the street and have lost any equity in their home in the process.

I think this is precisely the kind of problem now occurring on such a broad scale that it requires the kind of response we're talking about and, if I heard you correctly, you were very emphatic in saying that this is not a grant of money in any way. This would be a loan program. The money would be repaid. The equity in the house stands as a collateral against the loan. With this loan people would remain in their homes and have a fighting chance to keep their homes until such time as the economy recovers and they are back on their feet financially. That's the thrust of what you're asking us to do?

Senator **Specter**. Precisely. It can be structured as a loan with a lien for security for the governmental advance.

I might add just this one more note, and that is that there is dismay where I have visited on our foreign aid program and the President's speech, of course, of last Wednesday night was fresh on the minds of the people in western Pennsylvania in the five open houses which I held, and they asked a very simple question and that is, how can the President propose money for El Salvador and $600 million for Central America at a time when they have no health insurance, our unemployment compensation has lapsed, and our houses are being foreclosed? And other questions were raised on the question of national defense and on the MX missile, how can we allocate $20 billion to the MX missile with all of the attendant problems at a time when these severe problems exist at home?

They are very logical questions which are being asked by the people of our country on this subject and if there is a response on matters of urgency like foreclosures, health insurance and so on, then there is more of a comprehension as to the other business that we are transacting here in Washington.

Senator **Riegle**. You make a powerful point and I'm going to do anything I can do, working with Senator Heinz and others on the committee, to see if we can't bring this bill through successfully, have it passed on the Senate floor and enacted into law so we can respond and help these people.

Senator **Tower**. Senator Heinz.

Senator **Heinz**. I just want to commend my friend and colleague for an excellent presentation. I have no questions.

Senator **Lautenberg**. Before I'm left out here, Mr. Chairman, we are from neighboring States and share common problems and certainly I think the thrust of your request is more than reasonable. New Jersey also has some very unpleasant experiences right now and faces the prospect in many areas where jobs that were held for many years may not return because companies have closed and it doesn't look like there's anybody to pick up in some of these areas. I think it's something we have to do. I would not like the thought that Pennsylvania is the only State with humane sheriffs and I'm going to look around and see if we can't find some of those who refuse to observe the law and foreclose on some of these homes. I think the case made not only by Senator Specter but by so many people out there who are distressed by the prospect of losing the principal asset that most American working families have. It's a very serious problem and I hope that we'll be able to do something about it in a short order of time so the pain doesn't endure any more than it has to.

I was encouraged, Senator Specter, and I know it wasn't a partisan issue, but to hear you make an appeal to the President to be more lenient in some of these matters. I will certainly carry that message around in my State. Thank you very much.

Senator **Tower**. Senator Specter, thank you very much for some very helpful testimony. We appreciate your presence.

Senator **Specter**. Thank you, Mr. Chairman. I appreciate your courtesy.

Senator **Tower**. If you would like to submit anything in addition for the record we would be glad to receive it.

Our next witness is the Honorable Lawrence A. Kudlow, the Associate Director of Economics and Planning, Office of Management and Budget.

Mr. Kudlow, I see you have a prepared statement here. You may submit this for inclusion in the record in its entirety or summarize it as you choose.

STATEMENT OF LAWRENCE A. KUDLOW, ASSOCIATE DIRECTOR FOR ECONOMICS AND PLANNING, OFFICE OF MANAGEMENT AND BUDGET

Mr. **Kudlow**. In my prepared remarks, I have touched on four or five general points, of course, relating most importantly to the FNMA Charter Act amendments. Also, at the request of the subcommittee, I have included a brief statement of the administration's position on mortgage foreclosure relief that was just discussed by Senator Specter.

By way of background, before going directly to FNMA, I'd like to review if I may very quickly some of the recent developments in housing which I think bear on this, as well as a brief review of the administration's prior views and statements on Federal credit both on the budget and off the budget.

HOUSING RECOVERY BECOMING A BRIGHT SPOT

The first issue is housing and of course I'm rather pleased, as everybody is, to note that in terms of expectations and hopes for economic recovery since last fall housing has been one of the brightest spots and one of the more consistent performers. The data are good and continue to come in strong.

Housing starts are up about 1.7 million total starts the first quarter of this year. Single families have grown to 1.1 million. The rate of increase from the bottom of the deepest point in the housing recession which seems to have been the fourth quarter of 1981 we're running almost a 100-percent increase.

It's worth noting also, Mr. Chairman, that at this stage of the business cycle for housing where we are running approximately five quarters from the bottom, we are actually ahead of any prior housing expansion in the post-World War II business cycles. We are up indeed on average more than most of the recoveries in housing, total recoveries in housing, that have occurred in the post-World War II business cycle, and I submit a chart of this on page 2 of my testimony just to show you that we're running stronger than the strongest cycle in housing which began in 1975, and we're running even more above the average cycle in housing measured by all the six postwar recoveries. So we have made great progress in this area.

I'd also like to point out the administration's view that this has come principally from the large reductions in inflation and interest rates which have had very beneficial impacts on housing and all these areas. It has not come, we are grateful to point out, from large new spending or loan programs. Indeed, the administration has tried to maintain its goal of budget restraint throughout this housing discussion though it has been a difficult period in the last couple years.

But mainly it's reduction in inflation and the corresponding reduction in interest rates so that homeowners now are able to get mortgages a little more cheaply. Mortgage rates are down to about 12 or 13 percent. That's still very, very high and I certainly concede that point, but it's a lot lower than the 18 or 19 percent we had at the worst moments and I think, as you know, there are a lot of private financing deals for which evidence and data is not really available that get the mortgage rate a bit lower.

So my point is not to crow about a 13-percent mortgage rate, but merely to note that it's a lot of progress and it has been a great stimulus to housing and those numbers are coming in very, very strong.

I would also add a note of caution on this I'm sure you appreciate. We have to worry about sustaining this housing recovery over the next several years and in fact one of the great worries that I have, shared by many people, is unless we are able to make some further progress on the fiscal situation with respect to Government borrowing of all kinds, on and off the budget, we run the risk that as the economic recovery in other industries begins to heat up we will get a crowding out—we will get interest rate pressure and we'll get heavy competition with the Federal and private sector for capital and we run the risk of higher interest rates which will actually undermine this housing situation.

So I don't think we're home free by any stretch of the mind, so I think we have to bear in mind this fiscal borrowing problem. But housing at least is a bright spot.

OPPOSE EXPANSION OF FEDERAL BORROWING

In the area of Federal credit policy, I have not appeared before your subcommittee before but I have appeared before many other committees and subcommittees, and I believe the administration's view has been quite consistent since taking office in early 1981. We have opposed any expansion of federally related borrowing, particularly in the budget areas that are not recorded in the unified budget, such as loan guarantees and the debt placed by federally sponsored agencies we'll discuss in a few moments, FNMA and FHLMC and so forth and so on. We have opposed the expansion of this borrowing for a variety of reasons, mostly on grounds of economic efficiency.

We prefer to see the Federal Government consume less capital and the private sector use this capital because we believe the private sector will use it more efficiently and more productively. We don't like subsidies. We feel that they're inefficient and costly and, moreover, in recent years, the avalanche of debt from all these sources which has been staggering has, in our view, kept interest rates much higher than they would otherwise have been, and although rates have come down a lot and we are pleased with that progress, the fact remains, as I'm sure you know, interest rates right now are still too high in the early stages of this recovery.

So much of this is a function of debt from budget deficits, debt from the off-budget FFB, borrowing for the loan guarantees, and the Government sponsored agencies, and I am concerned again in this borrowing aspect that we may look out ahead and worry about interest rates and monetary policy, future inflation, and growth and so on.

I would like a couple of numbers to present on the credit expansion of federally sponsored agencies. In 1974 which was a comparable recession year to 1982—I'm going to use trough to trough if I may. In 1974, total borrowing by the Government was $24 billion or 13 percent of the U.S. credit market capital. In the recession year 1982, 8 years later, essentially two troughs later but we're ignoring the 1980 situation because it was so brief, Federal borrowing in sum was nearly $200 billion and almost 50 percent of the U.S. credit market activity. We've gone from 13 percent absorption to 50 percent absorption and we've managed to do that in a quick 8 years. So this is the reason why we are concerned with this kind of borrowing expansion and we remain concerned.

With respect to the federally sponsored agencies of which FNMA is one of the most important, the borrowings of these institutions have grown substantially. By our reckoning, using the 1974 and 1982 comparison, agency borrowing has gone up by about 300 percent. As I mentioned before, as a matter of policy, the administration is trying to hold this borrowing down and as stated again in the 1984 budget we are trying to find a strategy, a longer term strategy, working with the Congress and the agencies and the public groups, to seek some way to generate a better balance in the secondary mortgage market area which is the principal area for these Government sponsored agencies—a better balance between the Government institutions and the private institutions.

Right now, in our judgment, there is substantial imbalance where these markets are dominated by only a couple of Government backed institutions and very, very few private institutions. Over time, Mr. Chairman, we continue to carry the stated goal of privatizing these agencies, but this is a long-term goal and we'll discuss this in a few moments. In the meantime, I just want to review our own policy objective.

In looking directly at the FNMA Charter Act amendments, which we count 11 right now, let me briefly recount several policy principles that the administration has developed and used in evaluating this bill, the FHLMC recapitalization bill of 1982, and the broad issues of federally sponsored enterprises.

The first priority in policy terms, of course, is to help housing, and in the current context as I mentioned a few moments ago we are mindful of the need to take steps to sustain the housing recovery underway and I will only repeat quickly that I'm worried about the effect of big borrowing in sustaining that housing recovery over the next several years.

Second, we are concerned and we have a large interest to contribute to the effort to rebuild the strength and the solvency and soundness of FNMA. FNMA, of course, is directly linked to the Government and therefore its contingent liabilities on its balance sheet in many respects contains liabilities against our balance sheet.

In 1982 we helped FNMA by providing support for their request for tax reform changes, the 10-year loss carryback and the 5-year loss carryforward. It will cost us $155 million on the budget in 1983, but we felt that is worth it because it will certainly help bolster the solvency of FNMA. We worked with the agency and its fine chairman in helping to get this measure through.

SOLVENCY OF FNMA

More fundamentally, in the last year or so, it seems to me the combination of lower interest rates on the one hand and some very creative management changes, again by the new chairman and his team, have improved the financial situation of FNMA quite a lot. They're up to $15 million for the first quarter's earnings. That's a big turnaround from the $43 million loss the same quarter a year ago, and I note as I'm sure many of us do that the stock price has gone from about $9 a year ago up to about $28 today. This is another signal that public confidence in FNMA is improving.

I would add one footnote on the solvency question of FNMA. The balance sheet is improving and the income statement is improving, but I think it's still too early to say that recovery of the patient is complete. Most people who evaluate the agency feel that it will take several years for it to regain full solvency and we agree. And in that respect, we feel it would be unwise to make substantial increases in the scope of FNMA's operations or to incur major new contingent liabilities during this balance sheet-income statement recovery period.

In a business, Mr. Chairman, that was close to falling out, we want to go slowly. We want to consolidate. We want to improve our debt situation. We want to bolster our balance sheet. We want to make sure everything is in order before we took major new risks. And I think the same is true with FNMA. We would prefer to go slow on that rather than to go rapidly.

Now a third policy principle regarding these agencies is the fact that there is a growing desire by many private sector firms, to get into the secondary mortgage market, large firms, medium firms, and small firms. We've had a lot of increase in the Office of Management and Budget, in the Treasury and so forth, of people who have come to see us. This is a function of the improvement in the housing conditions. It's a function of the better tone in money markets. People feel this is a good business. It's a business where profits can be made and, most importantly, it's a business where there is very little private sector activity at the present time.

Moreover, the administration has tried to respond to these private sector increases by putting together a package of deregulatory and tax measures which will I think remove many of the existing barriers and help the private sector grow in the secondary mortgage market area. We have discussed with members of the subcommittee staff and we hope to present a complete package in this area in a short period of time.

The problem is in this private sector part that the most formidable barrier to entry is the existence and the growth of these Government-sponsored agencies. That's the problem we have and it is a problem because of the many statutory linkages and special Federal characteristics which have been granted these agencies in their charters—Treasury borrowing lines, Federal Reserve collateral, Federal Reserve fiscal agency status, exemption from SEC registration disclosures—there's a whole laundry list and I have placed that in the appendix—and the sum total effect of this laundry list is to create the widespread perception in the financial markets and elsewhere that the Federal Government has a moral obligation to back and support the commitments and operations of these agencies. Hence, the notion of Federal sponsorship.

In the financial markets the widespread view is in FNMA's case, for example, that the papers should trade just like Government bonds, just like Treasury issues. In fact, we observe in charting the interest rate trends over a period of many years that FNMA paper indeed trades a little higher in yield over Treasury paper but much lower in yield from corporate bond paper which is fully commercialized and fully private. The numbers are interesting in this respect.

Over the period from 1975 to 1982 we used 7-year maturities, FNMA's, Treasury's, and AA-rated corporate bonds. The FNMA bonds were 16 basis points higher in yield than the Treasury bonds, but the FNMA bonds were 63 basis points lower in yield than the corporate bonds because of the implied Government guarantee.

Now this has some interesting effects and I want to be very clear about this. First of all, if these agencies can finance at lower interest rates, that means that they can raise money in the capital markets more cheaply than their private sector counterparts by a wide margin and that's unusual and unfortunate because we know, for example, in the case of FNMA that they've had a lot of problems that would have undermined their creditworthiness in the eyes of the marketplace but instead, because of the Federal backing, it need not produce any kind of credit rating from Standard & Poor's or Moody's or anything of that nature because the market recognizes that Uncle Sam stands behind it and, of course, because of this enormous Federal characteristic and the power of the moral obligation, FNMA and its sister agencies have the power to issue large quantities of debt securities just like the Government can or to insure large quantities of existing debt securities and contingent liabilities much in the manner of the U.S. Treasury.

On page 13 I've shown you another picture. I don't want to go too far. I know quantitative analysis has its limits. But I do want to illustrate over this 7-year period a picture of this continuous spread in this long-term and medium-term market. You can see the lowest yield continuously of the 3 is the 7-year Treasury bond. Trading right on top of it is the 7-year FNMA. Now a little bit of a spread has opened up in the last couple years, but still the position of FNMA is unchanged because, importantly, it trades at a lower price, a lower interest rate than the 7- to 10-year AA-rated corporate bond paper and a AA rate is a fine rating in the industrial sector or utility sector. Indeed, small and medium sized business firms that want to get into this area have trouble getting a AA rating today.

Now this puts private firms at a major disadvantage and it's not only the interest rate factor and it's not only the credit factor. In addition to that, the private firms that want to get involved in this area have to go through the SEC registration, disclosure and rulemaking process, and that entails a lot of costs. It's not cheap to do that the first time and it's not cheap to do it over a period of many years.

In addition to that, they must incur more costs to seek private mortgage insurance if they are going to get involved in these secondary markets and that, too, entails costs. And when you put this whole picture together, what you have is a case where the private people have to pay higher interest rates which is expensive. They have to go through regulatory processes which are expensive. They have to find insurance which is expensive. You sit down and map this out in a 5- or 6-year corporate budget plan everybody has to go through and you say, well, it looks like they're going to have a higher cost structure than our Government competitors, potentially lower profit margins and probably more limited credit assets. It's a very difficult burden which represents a barrier. I feel and the administration strongly recommends that we take some steps to remedy this and create what I'm describing this morning as a better balance between the Government sector and the private sector in this area. It's just a question of balance.

I don't think it ought to be a question of one or the other alternative. It's simply a question of whether we've weighted too much in this area on the Government side and not enough on the private side.

So, Mr. Chairman, to create this better balance, our fourth policy principle—in many respects you're hearing the most important—we feel that any major changes in these federally sponsored agencies with respect to their structure, their programmatic operation, their scope and so forth, must include a provision to reduce at least some of their ties or linkages to the Federal Government to create better balance and to make the private sector advance more competitive.

COMPETITION BETWEEN FEDERAL AND PRIVATE SECTOR

Now I want to add here, very importantly, we must do this in a cautious way. We must do this with great thought because we do not want to disrupt either the agencies themselves or the promising developments in the housing recovery, but notwithstanding, as I'll discuss in a few moments, I think this should be quite possible and I would only add in terms of a background for our policy view, we do not believe the housing sector, the financial end or the secondary mortgage market area are best served in a situation where it's completely dominated by the Government.

I don't think you get the kind of competition, discipline, rigor, creditworthiness, toughness, leanness, and efficiency that is usually caused by the discipline of the profit oriented private sector. In fact, over time more competition and more balance between the Federal sector and the private sector will lead to a broader array of housing finance services better fitted to investors, homeowners, and mortgage buyers. These services will be better tailored to their needs, more diverse, and provide a greater array of better services at the lowest possible prices. I think that's what competition will do over a period of time and I think that's the direction in which we ought to move.

The final point I want to make about our policy is not a small issue. We have, of course, a number of these Government-sponsored agencies. FHLMC, the Federal farm system, SLMA, as well as FNMA. The administration in dealing with these agencies is trying to work out a long-term policy and that is a task. We have tried to stress the concept of parity, equal competition, and an equal playing field for these agencies now in finance. I think this is very important with respect not only to the health and financial solvency of the agencies themselves, but I think we want to avoid unfair competition which might prove disruptive to the credit markets who will try to figure out what the Government is really up to. Also if the competition among the agencies is allowed to get out of hand, as I fear from time to time it has, it tends to create a contentious atmosphere which is not helpful. So we would like to stress the need for parity and equality and constant good faith as far as this policy is concerned.

As far as our specific recommendations, the administration has decided to take a two-track approach which we feel is constructive and which we feel can lead to compromising dealings over time. We feel this approach will advance our concerns about balance in the market with the FNMA interest of improving its own solvency and some of its other programmatic requests.

Let me be specific. Six of the amendments, three of which involve HUD regulations so in fact it's really four areas, have been found by the administration to be objectionable so long as FNMA has any sponsorship with the Federal Government. We feel it would be taking unfair advantage of its Federal status, and I will return to that in a moment. However, the remaining five amendments we feel ought to be looked at and discussed and indeed we could see our way to supporting those five amendments if we could generate some reduction, even a small part, to FNMA's ties to the Federal Government. We could support a new proposal which would withdraw the six objectionable amendments and maintain the five amendments if added with some reduction of the FNMA ties to Uncle Sam.

We feel it would move FNMA a few steps in the direction of becoming a more private firm. It would provide the private sector people with a more competitive situation. We would be moving in the right direction and it would help to remedy the administration's concern over the imbalance between the public and private sectors.

Now directly on the amendments, the removal of maximum mortgage loan limit amounts we feel would be a major expansion of FNMA into a high income market it does not need to serve and has not been chartered to serve. We would prefer it to have a more limited role which is designed to keep an eye toward the low income and middle income housing areas, not the high income housing areas.

By the way, it's exactly in the higher income areas that the private sector people would like to move initially.

Senator RIEGLE. Why is that? Could you just tell us why this is? Why do the private sector people like the high income part and not the rest?

Mr. KUDLOW. Right now, Senator, it's the only area open. It's the only area not covered by FNMA. I think over time the private sector people would like to jump into the middle income area, but in a marketing sense right now they are just completely blocked out.

Senator RIEGLE. You don't feel the high end is more profitable and more attractive generally?

Mr. KUDLOW. I honestly don't think we know because in terms of profits it's hard to say. The pricing is often very competitive at the upper end and the volume is not large and frequently unstable. So I can't with certainty give you a direct answer.

Senator RIEGLE. I think common sense tells you that the high end is less risky and has the preferable investment opportunities and that the private sector has historically sought those markets and will continue to do so. It's not surprising to me that anyone who competes across the market would also want to go after the less risky, higher profit business. I don't understand how you can make the argument to the contrary.

Mr. KUDLOW. Well, you'll hear later in the hearing from some private sector people who are involved in this. They are more expert in terms of the market shares and the profits and so on.

From our standpoint of public policy, the short answer is it's the only area open.

Now in terms of the profit margins, you may well be right. I just couldn't say because I've never looked at it. There's a lot of volume in the middle area.

On the second point of adding authority to offer a FNMA-type security program, we think this too would be unwarranted expansion. We would have a tremendous new wave of debt securities with the FNMA stamp. Again this would exacerbate the borrowing problem and the crowding out problem. Suddenly all kinds—indeed maybe all—secondary mortgage market paper would become FNMA paper. It would also generate a new increase in the contingent liabilities of the FNMA balance sheet and indirectly the Federal Government. I think this is an inappropriate time for that kind of rise in the balance sheet responsibilities and, as I indicated before, FNMA is already borrowing a substantial sum in the marketplace.

New asset powers is a request for nonresidential mortgage powers. We don't feel it should be granted at the present time. This would be a major new area for FNMA. Shopping centers, warehouses, commercial loans, joint ventures, and all the rest. I believe the private sector can adequately serve this area and indeed is at the present time. So we feel nonhousing related activity is inappropriate. It would be too risky again at a time when FNMA is just beginning to recover its financial solvency.

AMENDMENTS ON HUD OVERSIGHT

In terms of the three amendments on HUD oversight, Mr. Chairman, we feel right now oversight is important because the agency is linked to the Government and we have an interest in its situation. Programmatically and traditionally, the Department of Housing and Urban Development has always carefully watched FNMA, and in view of the financial recovery progress and process, we would want that to continue.

Now the second set of amendments where we are more hopeful we could arrive at some compromise and support I have listed on page 19. These are: FNMA and HUD submitting reports to Congress, a change in the composition of the board of directors, removal of the loan value restrictions on FNMA multifamily mortgages, limited voting rights granted to preferred stockholders, and removal of the overcollaterization requirement and restrictions on FNMA loans against the security of the mortgages. We think these are areas that FNMA is correct and prudent in requesting new powers. But again, we feel that consistent with our concerns about the imbalance between the Government and private sector, the desire of the private firms to become more competitive and move into the secondary mortgage market area to serve consumers is important. In order to grant these new powers, we would recommend to the Congress that some reductions as a first step be made in reducing ties to the Government.

Now I have listed some of the major ties on page 20. In the appendix to the testimony I have listed fully the 11 special benefits, and the six Federal controls. I will only say at this point it is these special benefits and Federal characteristics which have created the widespread market impression that FNMA is part of the U.S. Government or at the very least the U.S. Government has a moral obligation to support its operations. This is the key area.

We do not at the present time come to this hearing and this discussion with any fixed or predetermined views about what linkages ought to be severed or how much. We feel that this is a point that we ought to discuss these issues. I am proposing that we set up, if the committee can see its way, a consultative process where members of the committee and their staffs, members of FNMA, members of the administration, and perhaps even people from the other Government-sponsored agencies would sit down quickly and discuss this new proposal that we are recommending this morning, discuss the possibility of granting some new powers along with some reduction in Federal linkages and, indeed, Mr. Chairman, at this point it may be possible even to broach the subject that other Government sponsored agencies might want to take similar steps. Furthermore, we might want to even evolve some kind of recommendations to do this.

I feel that this is a constructive response to the FNMA request. I feel we are at this point in time unwise if we simply say no, no, no. That is not our objective. Our objective is to work with them and the other agencies to solve some of their ongoing problems and at the same time to deal with some of the public policy concerns that the administration has and I hope that are shared by Congress.

As a last thought on this, in no way are we proposing any radical departures or changes with respect to the issue of these Federal characteristics. That would be unwise, too. That would be damaging. On the other hand, I think the time is ripe now, with housing on the up a little bit and financial conditions having improved, there's a lot of interest by business to come in now. That is, of course, caused by better economic conditions. It appears to be an appropriate moment to do two things. No. 1, to develop a clear and concrete strategy with a timetable, and I believe we can do this through the consultative process; and No. 2, to make some small steps toward implementing this process in calendar years 1983, 1984. I think now is the time. We puzzled over this issue for several years. We've talked about it. We've analyzed it. We've created themes and guidelines and so forth, but we really haven't taken any concrete steps to solve it.

There's competition among the agencies that I think is not healthy. There's competition between the agencies and the private sector counterparts that I think is unwise and poorly serve the public. I think now is the appropriate moment to make some policy changes. It's a tough issue. So we think additional discussion is necessary, but I will say this, the administration rejects the notion that all positions on all sides are hardened and inflexible and there's no hope for compromise. We refuse to take that position. We are much more constructive and I am convinced that we can make some progress in this area.

Thank you. That's all I have.

[The complete statement follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

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STATEMENT OF LAWRENCE A. KUDLOW
ASSOCIATE DIRECTOR FOR ECONOMICS AND PLANNING
OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss the Administration's views on the latest version of the proposed Federal National Mortgage Association (FNMA) Charter Act amendments. In addition, at your request, I will also touch on the second topic of the subcommittee's deliberations today -- the Administration's views on mortgage foreclosure relief.

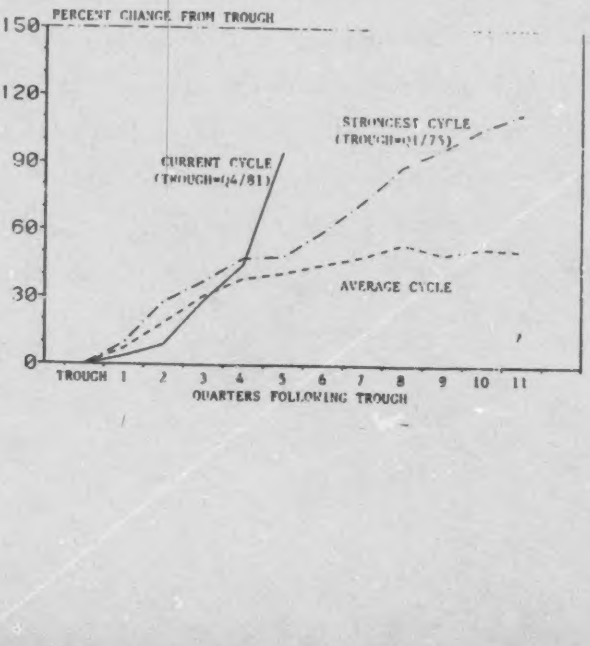
Before moving to the specifics of the FNMA proposal, as background information I would like to briefly discuss the encouraging recent developments in the housing sector and then quickly review the Administration's past views regarding the problems of Federal and Federally-sponsored credit expansion.

Strong Recovery in Housing

One of the earliest, strongest and most consistent signs of economic recovery has occurred in the housing area. Total housing starts in the first quarter of this year (at a 1.7 million unit annual rate) are nearly twice the level of a year ago, and the highest level in 3 1/2 years. Starts of single-family units (1.1 million unit rate), are up 83% over the year-earlier level. Total new housing permits are also up sharply with the first quarter 1983 level (1.5 million units) more than 80% higher than a year ago.

At this stage of the business cycle, five quarters from the housing trough of October 1981, this is the strongest housing recovery since World War II.

- The 95% gain in total starts since the housing trough in the fourth quarter of 1981 is nearly twice the 49% increase in the comparable 5-quarter period of the best previous housing recovery in 1975-76.
- The current upturn also substantially exceeds the 55% increase in starts achieved during the entire period of the average of the 7 postwar recoveries.



HOUSING STARTS
CURRENT HOUSING CYCLE VS PREVIOUS CYCLES

The housing recovery has not come about as a result of a flood of new government spending or loan programs. Instead, the recovery in housing is principally due to the positive effects of the significant reduction of inflation and interest rates experienced during the past two years.

- Reduced inflation has made housing more affordable. In 1978-79, prices of existing homes increased about 16 1/2% per year, nearly double the 8 1/2% annual increase in the CPI. In 1982, the picture was completely reversed with home prices increasing only 3%, half the rise in the CPI.

- Reduced inflation has also brought about a marked reduction in mortgage interest rates, from a peak of 18.5% in October 1981 to 16.9% a year ago and to 12.8% currently. Private financing arrangements, for which data is scarce, have brought effective mortgage rates even lower.

- Lower inflation has also bolstered the purchasing power of take-home pay. In the past year, real average hourly earnings rose about 2%, a reversal of the 3 1/2% average annual decrease in 1979-80.

- Household balance sheets have improved markedly. On the asset side, the rise in stock and bond markets since mid-1982 have boosted households' net worth by about $700 billion. On the liability side, housenolds are well-placed to increase debt. Consumer installment debt burdens have fallen sharply in recent years. Installment credit outstanding as a share of disposable personal income declined steadily from nearly 18% in late 1979 to 15 1/4% currently.

With the current housing recovery on a record track, policy decisions must focus on ways to sustain this early progress into a fully developed recovery lasting several years. It is widely agreed that interest rate movements will be a dominant factor. With this in mind we must all recognize that as the recovery gathers momentum during the next year or two the problem of heavy Federal borrowing -- in the form of direct Treasury borrowing on- and off-budget, new loan guarantees or the issuance of debt by Federally-sponsored agencies -- represents a considerable threat to sustaining the recovery over time. New spending or loan assistance may be offered with the best of intentions, but the financial market impact of such decisions is likely to cause higher interest rates and a weaker recovery. Hence, a policy of budget and credit restraint must be a high priority to assure future strength in the housing area.

Federal Credit Policy

In recent years the rapid expansion of Federal and Federally-assisted borrowing in all areas -- direct loans, loan guarantees and government-sponsored agency debt -- has generated a number of seriously adverse economic and financial consequences. As a result, this Administration has consistently sought to implement a Federal credit policy of reduction, not expansion.

- The growing Federal consumption of capital that could be more efficiently employed if left in private hands has caused a misdirection of investment resources and has substantially inhibited capital formation and economic growth.

- Federally subsidized borrowers are nearly always less productive than unsubsidized borrowers, in large part because this growing Federal intervention has distorted the market's assessment of true risk and return and weakened the normal bottom-line discipline of profitability and creditworthiness.

- The avalanche of new Federal and Federally-sponsored debt issues continuously offered to the market will keep interest rates higher than would otherwise be the case, forcing all private firms to shoulder more expensive financing costs and in many cases crowding out unsubsidized private borrowers who cannot absorb the higher interest expense.

- Particularly during the more advanced recovery phase of the business cycle, upward interest rate pressures generated by heavy Federal borrowing requirements can be expected to pose serious complications for the appropriately restrained conduct of monetary policy. In this context, the sheer size in terms of assets of the Federally-sponsored agencies, in general, and FNMA in particular, must be considered when making macro-economic policy decisions.

Table 1

Federal Absorption in Domestic Credit Markets
(in billions of dollars)

	1972	1973	1974	1975	1976	TQ	1977	1978	1979	1980	1981	1982
Total funds raised in US credit markets *	151.9	198.5	187.5	177.9	243.1	64.8	308.3	383.4	426.4	366.4	427.2	408.7
Raised under federal auspices	39.1	46.5	24.2	64.8	98.1	19.3	79.0	93.9	80.7	123.5	142.1	199.7
Federal borrowing from public	19.4	19.3	3.0	50.9	82.9	18.0	53.5	59.1	33.6	70.5	79.3	135.0
Borrowing for guaranteed loans	18.9	16.6	10.3	8.6	11.1	-0.1	13.5	13.4	25.2	31.6	28.0	20.9
Government-sponsored enterprise borrowing	0.7	10.6	10.9	5.3	4.1	1.4	12.0	21.4	21.9	21.4	34.8	43.8
Federal participation rate (%)	25.7	23.5	12.9	36.4	40.4	29.8	25.6	24.5	18.9	33.7	33.3	48.9

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* Nonfinancial sectors, excluding equities.

Source: Federal Reserve Board Flow of Funds Accounts.

Table 2

Government-Sponsored Enterprises: Net Change in Outstanding Loans
(in billions of dollars)

	4-year averages		Actual Annual Data					Estimates	
	1970-73	1974-77	1978	1979	1980	1981	1982	1983	1984
Federal National Mortgage Association	3.3	2.8	7.0	8.0	6.5	4.1	17.3	28.6	25.0
Federal Home Loan Mortgage Corporation	0.5	1.5	4.4	5.0	3.1	0.3	17.0	18.8	18.9
Federal Home Loan Banks	1.2	1.5	12.1	9.9	6.5	20.5	2.4	-2.9	-0.4
Farm Credit Administration	1.8	4.8	4.4	8.5	12.5	10.0	5.6	9.7	10.7
Total, unadjusted	6.8	10.7	28.1	31.9	29.6	37.0	43.9	56.2	55.3
FNMA as percent of total	49	26	25	25	22	11	39	51	45
FHLMC as percent of total	7	14	16	16	10	1	39	33	34
FHLB as percent of total	18	14	43	31	22	55	5	-5	-1
FCA as percent of total	26	45	16	27	42	27	13	17	19

In the recession year of 1974, Federal and Federally-sponsored agencies borrowed a total of $24.2 billion, or 12.9% of the non-financial capital raised in U.S. credit markets. During the recession year of 1982, however, total funds raised by Federal entities jumped to $199.7 billion, or 48.9% of the non-financial domestic credit market. Hence, the Federal absorption rate has jumped by 36%, while the actual level of funds raised has increased by a staggering 725%. In the Administration's view, unless these credit trends are reversed, the expectations of strong economic growth and low inflation in the 1980's will be particularly difficult to achieve.

Federally-sponsored Agencies -- Key Policy Principles

With respect to the growing credit needs of the Federally-sponsored agencies, where borrowing grew by 300% between 1974 and 1982, the Administration's policy continues to emphasize the need for longer-term plans to prevent excessive debt expansion and to gradually reduce the Federal sponsorship of these agencies with the final objective of full privatization. In the 1984 Budget submitted to the Congress, this policy was stated as follows:

> "The Administration ... remains committed to seeking the total privatization of two of the housing-related government-sponsored enterprises, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Because of their Federal government sponsorship these enterprises receive special advantages in the securities market that completely private institutions do not have. An interagency Cabinet level group will continue to pursue the goal of complete privatization of these enterprises."

In reviewing the proposed FNMA Charter Act amendments, the Administration utilized several policy principles as guideposts. First, of course, is the need to sustain the impressive housing recovery now underway. The substantial interest rate reduction of the past year has provided significant stimulus to housing and other sectors, but we must remain mindful of the continuing threat to interest rates and economic recovery posed by the burden of unusually large government borrowing requirements projected during the period ahead.

This financial market burden is not only a result of the funding necessary to support the on- and off-budget deficits, but it is also a consequence of the credit market strains that are likely to result from net increases in Federal loan guarantees and the new debt generated by the Federally-sponsored agencies. Federal credit demands may not prove troublesome in the current stage of economic recovery while private credit demand is weak. But as the recovery cycle matures and private credit demand heats up, continued heavy Federal borrowing will surely generate upward interest rate pressures and an unwanted slowdown in housing and other forms of investment.

A second policy factor is the Administration's interest, within prudent fiscal bounds, to contribute to the effort to rebuild the strength and solvency of FNMA. As you know, in 1982 the Administration supported P.L. 97-362, requested by FNMA. The change in law gave FNMA a substantial tax break. FNMA was given the 10-year loss carryback and 5-year loss carryforward treatment that certain financial institutions (e.g., thrifts) currently have. The new law will give FNMA access to refunds, not otherwise available to it, that are attributable to profitable years. These tax changes will result in an estimated $155 million in revenue loss to the budget for FY 83. But, more importantly, they will help bolster the solvency of FNMA, thereby heading off the potential need for even costlier assistance in the future.

More fundamentally, the combination of lower interest rates and a series of innovative management decisions has generated a substantially improved financial position of FNMA under its present charter. Positive earnings of $15 million were reported for this year's first quarter, quite a turnaround from the $42.8 million loss in the first quarter of 1982. FNMA's common stock price has increased from a low of $8.88 a share in the last year to $28 earlier this week, a gain of 215%, thus signalling a broad renewal of investor confidence.

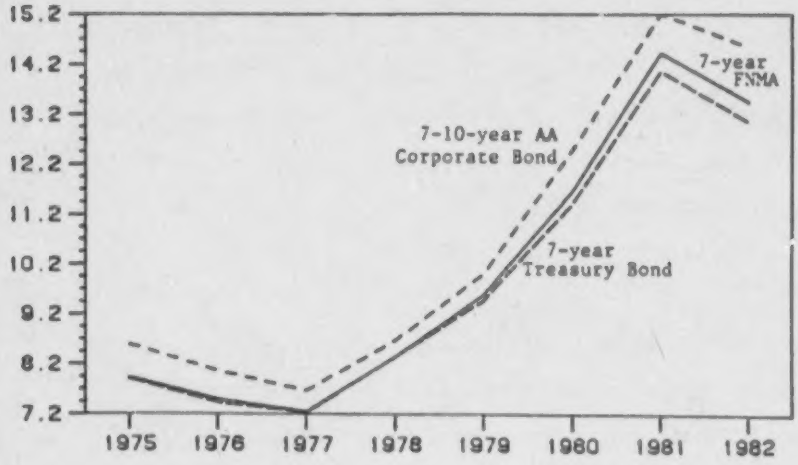
However, we must recognize that, as in the case of the entire housing sector, improvement in the FNMA balance sheet is still in an early stage of recovery. As all observers agree, it will take several years for FNMA to regain complete health. Consequently, it would seem unwise at the present time to substantially increase the scope of its operations or to incur large new contingent liabilities until financial recovery is completely assured.

A third and particularly important policy consideration in the Administration's review of the FNMA Charter Act proposals is the growing desire of a number of counterpart private sector firms to develop a significant presence in secondary mortgage market activity. One firm, for example, has secured $400 million in mortgage-backed security take-downs and commitments thus far in 1983, and, at this rate, the firm fully expects to exceed $100 million per month in mortgage-backed security activity for the year. Other firms have already filed, or have indicated a willingness to file, multi-million dollar shelf registrations with the SEC for future issuances of mortgage-backed securities. To help provide support for these commercial initiatives, the Administration has nearly completed work on a set of deregulatory and tax proposals designed to remove existing barriers to permit a much greater volume of private sector activity in the secondary mortgage markets.

Regrettably, the numerous statutory linkages (i.e. Treasury borrowing line, Federal Reserve collateral capability, exemption from SEC registration and disclosure requirements, etc.) between the Federal government and agencies such as FNMA, and the widespread perception that these special advantages imply that the government has a moral obligation to stand behind the commitments of these agencies, have placed formidable barriers in the way of private sector firms that wish to enter the secondary mortgage market.

The special benefits afforded these agencies by the Federal government provide them with highly significant advantages relative to their private sector competitors: 1) the agencies can finance their operations at interest rates that are lower than comparably dated private issues (over the 1975-82 period 7-year FNMA bond yields averaged 16 basis points above 7-year Treasury bonds but 63 basis points below AA-rated corporate bonds with 7-10 year maturities); 2) with strong Federal characteristics and the perception of the government's moral obligation, credit ratings are unnecessary; and 3) Federal statutes permit the issuance of new debt securities or the insurance of existing debt securities on a volume scale far greater than could be matched by fully private commercial firms.

SELECTED BOND YIELDS



In the capital-intensive mortgage finance industry, these are significant advantages. Moreover, private firms must incur the expenses of SEC registration and disclosure rules, as well as additional costs for private mortgage insurance. As a result, commercial firms attempting to compete with the Federally-sponsored agencies start out with a relatively higher cost structure, potentially lower profit margins and more limited credit market access. In these circumstances it is no wonder the government has become the dominant force in the secondary mortgage market.

To remedy these costly disadvantages, a fourth policy principle comes into play: significant changes in the structure, scope or mandate of Federally-sponsored agencies must also include provisions to reduce at least some ties to the Federal government, thereby creating better balance between the public and private sectors of the secondary mortgage finance industry by making the agencies more private and permitting private firms to become more competitive. Such adjustments must be given considerable study and forethought so as not to disrupt the normal activities of the mortgage markets or the operations of the agencies themselves.

However, over time, these steps toward privatization can serve as an orderly, useful transition path toward more efficient and market-oriented resource allocation, reduced government consumption of valuable capital, and a strong and entrepreneurial private sector to serve consumers in general and homebuyers in particular.

In our view the housing sector is not properly served when it is dominated by only two or three government-backed institutions that are not subject to the rigorous disciplines of competition, creditworthiness and profit-making that govern business activity in the private sector.

Any industry, be it housing or non-housing, will benefit from the widespread competition, diversity and efficiency that inevitably results from a private sector made stronger and more vibrant by the elimination of onerous regulations, burdensome taxation, excessive government interference or other barriers. In the housing area, we believe that policy actions designed to reopen the entryway for commercial firms will create a much sounder balance between the government sector and the private sector, leading to a broader array of housing-related services at the lowest possible prices.

The fifth and final policy consideration in the review process is the question of parity among the existing Federally-sponsored agencies during the transition period toward greater privatization. Unequal treatment of these agencies, including not only FNMA and FHLMC, but also the Farm Credit System agencies, the Federal Home Loan Banks, and Sallie Mae could harm the financial health of the agencies, would be likely to prove confusing and disruptive to the credit markets and might also generate a contentious and divisive atmosphere that would poorly serve the public in general or the housing sector in particular. Structural and programmatic changes for these agencies, including any reduction of Federal sponsorship, whether mandated by Congressional statute or administrative actions, must take great care to respect the concept of parity among the agencies. Constant communication and good faith candor are essential to this task.

FNMA Charter Act Amendments

Guided by this group of policy principles, the Administration has decided to take a 2-track approach with respect to the FNMA Charter Act amendments. Six of the amendments, three of which involve HUD regulatory authority, have been found to be completely objectionable so long as the agency has any sponsorship by the Federal government. At present, the Administration recommends that these proposals be withdrawn. However, the Administration would be able to offer support for the remaining five amendments if they are supplemented by a new proposal to eliminate or reduce some of FNMA's ties to the Federal government. In this manner, desired program changes can be undertaken within the context of gradually moving FNMA a few steps in the direction of becoming a private firm, thereby providing some relief to the substantial imbalance between the public and private sectors that currently exists in the housing finance area.

1) Objectionable Amendments

A) The removal of maximum mortgage loan limit amounts.

-- This will significantly change FNMA from its Federally-chartered purpose of meeting the needs of low- and middle-income households to a program geared to assist the wealthiest participants in the housing market. In terms of market share in the United States, FNMA already has the potential to serve 80% of the total dollar amount of single-family conventional loans with a mortgage loan limit amount of $108,300. (Appendix A provides additional details on this point.) It should also be noted that FHA insured mortgages loans are limited to $90,000.

-- Expansion to the upper income market would be inconsistent with the Administration's policy of a more limited government role designed to support areas clearly in need of financial assistance.

-- The expanded market share to service the upper income category, when coupled with FNMA's special advantage in the credit market, is likely to impede or prevent entirely the development of private sector initiatives.

B) Adding authority to offer a GNMA-type security program.

-- This would enable FNMA to substantially expand its operations while still closely linked to the Federal Government. By putting the FNMA stamp on mortgage pool securities, a new wave of Federally-sponsored debt will be created. Crowding out would become a more serious problem, with interest rate consequences that will affect both housing and non-housing investment.

-- There would be no legal or practical limit to the GNMA-type guarantee program. Assuming a considerable volume of these new debt instruments, an enormous contingent liability will be created against the FNMA balance sheet, and, indirectly, the Federal government.

-- Even without this power, FNMA net mortgage purchase activity is projected by FNMA to increase to an average annual volume of $23.6 billion in the 1982-84 period, a 300 percent increase over the 1978-81 average annual volume of $6.4 billion.

-- The authority would enable FNMA to guarantee the securities of all other issuers, giving FNMA substantial competitive advantages over other Federally-sponsored agencies and private sector counterpart entities. In short, it is likely that FNMA would completely monopolize the secondary mortgage market and eliminate any possibility of an enlarged private sector.

C) New Asset Powers

-- This amendment would expand secondary market purchase and sale powers to include non-residential mortgages (i.e., commercial loans, including shopping centers and FNMA equity investments in joint venture commercial developments) up to 10% of the previous year's mortgage purchases by FNMA.

-- Such expansion authority into non-housing related fields would be inappropriate for FNMA given its Congressionally-chartered purpose to provide only housing assistance to low- and middle-income households.

-- Participation in commercial loan markets would involve FNMA in riskier fields at a time when the corporation should be consolidating its financial position after the substantial losses of the last two years.

D) Removal of HUD regulatory oversight (3 amendments).

- While maintaining its full Federal sponsorship, along with a major expansion in its program scope, FNMA under this group of three amendments seeks a significant reduction of HUD supervisory oversight authority.

- However, Federal controls, primarily HUD oversight and program approval, are important to retain as long as FNMA remains closely linked to the Federal Government. This is particularly the case in view of the government's interest in FNMA's effort to regain full financial soundness.

- If at some point any new programs should be agreed upon, then the regulation oversight function becomes even more important during the transition phase.

2) Amendments that Could be Linked with Reduced Federal Sponsorship

The following five amendments could be combined with the removal or reduction of some FNMA linkages to the Federal Government.

- FNMA and HUD would be required to submit annual reports to Congress concerning FNMA's activities.

- FNMA's board of directors would be enlarged from 15 to 18 members, which has the effect of diluting representation of Presidential appointees (5) from one-third to 28 percent.

- The loan-to-value restrictions on FNMA multi-family mortgages would be removed.

-- Limited voting rights would be granted to holders of preferred stock, which would enhance the stock's value.

-- Over-collateralization requirements and term restrictions on loans made by FNMA against the security of mortgages would be removed.

3) Reductions in Federal Sponsorship

There are 11 special benefits and 6 Federal controls which firmly tie FNMA to the Federal government. These special advantages and privileges generate the strong Federal character that is associated with FNMA and has led to the judgement of the financial markets that the Federal government has a moral obligation to back the agencies' commitments and operations. (Complete listing in Appendix B). Among the most widely known and significant of the special benefit items are:

o U.S. Treasury line of credit of $2.25 billion;

o Eligibility of FNMA securities for open market purchases and as collateral for Federal Reserve Bank advances and discounts;

o Exemption from SEC registration and related accounting and disclosure requirements;

o FNMA securities counted as legal investments for Federally-supervised institutions;

- FNMA securities eligible to collateralize public deposits, including Treasury tax and loan accounts, and most state and local deposits; and

- Use of the Federal Reserve Banks as fiscal agents.

At the present time, the Administration has no fixed or predetermined views as to which of the special Federal characteristics should be reduced or removed in order to supplement the group of 5 non-objectionable amendments and create an expanded proposal that would be eligible for Administration support. Instead, we recommend a consultative process to discuss these and other related issues in the hope of gaining agreement for an expanded proposal.

This process might appropriately include members of this subcommittee and their staffs, the Chairman of FNMA and his staff, as well as representatives from the Administration. In addition, the views and perhaps also the participation of the other Federally-sponsored agencies would seem appropriate, bearing in mind the important principle of parity and the need for a smooth and equitable adjustment process if any changes are made. It would also be useful to solicit views from the public, Inasmuch as the key people likely to be involved in this have considerable knowledge of these issues, it may be possible to complete the consultative process and report back to the subcommittee in a relatively short period of time.

It is our hope that the subcommittee can see its way toward approving these recommendations. In our view they amount to a constructive response both to FNMA's requests and the Administration's concern over the sizeable imbalance that currently exists between the public and private sectors of the housing industry.

At the present time for a variety of reasons, it seems clear that radical changes in the relationship between the Federal government and the Federally-sponsored agencies would be disruptive and undesirable. Privatization will not occur overnight. However, with housing conditions showing solid improvement, generating substantial new interest in the financial side of the economy, it appears to be an appropriate moment to develop a clear policy strategy for these agencies and to make progress toward implementation.

The FNMA Charter Act proposals raise a number of difficult and broad issues for which there are no easy or quick answers. For this reason, the Administration believes that additional analysis and discussion are necessary. We reject the notion that all positions are hardened and inflexible, with no hope for compromise. Rather, we are convinced that progress in this area will be possible.

Comments on S. 846 -- Unemployed Homeowners' Mortgage Assistance Act

Let me turn for just a moment to another item which the committee is considering today, Senator Heinz' mortgage foreclosure assistance bill. The Administration opposes mortgage foreclosure assistance legislation, whether it be in the form of a direct loan or loan guarantee. It is clear that lenders are currently exercising a good deal of forebearance in considering how to handle homeowners who are in arrears on their mortgage payments. Federal programs which require lenders to initiate foreclosure in order to be assisted may very well prove counterproductive.

While the Heinz bill does not initially involve Federal funding we believe it could very easily result in large outlays. This is because the program would cause the delinquent homeowner to pile up additional debt using his home as collateral. In many cases, the resulting balance of total loans taken out against a home may be in excess of what the home is worth. Given the increased likelihood of default that can be expected in such situations, it is likely that despite the good intentions of the bill's sponsor, the end result will be 1) to initiate foreclosure where it might not have occurred; 2) to dig the homeowner deeper in debt; and 3) to drag the Federal government into the picture with direct outlays and a subordinated claim on recovering its investment. Rather than starting down this path, we believe that the better course would be to steer clear of this whole matter and let the present economic recovery solve the foreclosure problem over the long haul.

Moreover, even if the bill could be amended to eliminate these problems, it is not clear that the current unemployment situation has led to such severe mortgage foreclosure problems that would warrant Federal intervention. The conventional foreclosure rate in 1982 -- reflecting the number of mortgages foreclosed as a share of all mortgages held by insured Savings and Loans -- was only .24%, or only one out of every 417 homeowners. This rate is less than half the postwar peak foreclosure rate of .50%, despite the current high rate of unemployment. The 1982 FHA foreclosure rate was .44%, only about one-third of the 1.14% rate in the 1973-74 recession. The point of these figures is that high unemployment rates do not necessarily translate into high foreclosure rates.

Lenders usually try to work out a solution to delinquency of homes that can be difficult to sell, particularly in weak housing markets. Furthermore, there are many reasons why homeowners default and have their homes foreclosed other than unemployment. These reasons include excessive use of credit, marital difficulties, and the amount of equity a homeowner has in his home. Therefore, the need for Federal intervention to reduce foreclosures because of current high unemployment rates needs to be substantiated and not just assumed. Thus, I repeat, the Administration's position is to avoid beginning a new subsidy program at this time and instead let the present recovery create an economic environment where foreclosure rates as well as delinquency and unemployment rates will decline.

Appendix A:
Maximum Mortgage Loan Limit ($108,300) Impacts

- During the past year, about 93% of the number of single-family conventional loans closed were for amounts less than the statutory maximum loan amount of $108,300. 80% of the total dollar amount of these loans were comprised of loans below $108,300 during the same time period.

- Even in high cost areas, such as San Francisco, California, 75% of the number of loans and 60% of the total dollar amount of loans were below the $108,300 limit. Moreover, the average loan amount in San Francisco in February 1983 was $103,000, which is $5,300 less than the maximum loan limit.

- In mid- (Chicago, Ill.) and low- (St. Louis, Mo.) cost areas, over 90% of the number of loans and 75% of the total dollar amount of loans were below the $108,300 limit. Average loan amounts were $59,000 in low- and mid-cost areas in February 1983, which is $49,300 less than the maximum loan limit.

- In sum, FNMA and FHLMC market share encompasses over 90 percent of loans closed and 80% of the dollar volume of these loans in the U.S. Thus, only a very small market area is available for private sector competition both in terms of number and dollar volume of loans closed.

Distribution of Single-Family Conventional Loans Closed
(Dollars in millions; loans in units)

Loan Amount Distribution by Area	February 1983			June 1982			February 1982		
	No. of Loans	Total $ Amount	Average $ Amount	No. of Loans	Total $ Amount	Average $ Amount	No. of Loans	Total $ Amount	Average $ Amount
All areas in U.S.									
Less than $108,301	5,164	269.0	.052	6,382	314.0	.049	3,835	192.5	.050
$108,301 + ...	435	67.7	.156	402	63.2	.157	353	55.3	.157
Total	5,599	336.7	.059	6,784	377.2	.055	4,188	247.8	.058
High-cost area: San Francisco, CA									
Less than $108,301	74	6.4	.086	36	2.8	.077	30	2.0	.067
$108,301 + ...	28	4.6	.164	11	1.6	.149	10	1.4	.142
Total	102	11.0	.103	47	4.4	.095	40	3.4	.083
Mid-cost area: Chicago, IL									
Less than $108,301	167	8.6	.051	257	14.2	.055	131	6.4	.049
$108,301 + ...	19	2.4	.124	30	4.1	.138	15	2.1	.139
Total	186	11.0	.059	287	18.3	.063	146	8.5	.057
Low-cost area: St. Louis, MO									
Less than $108,301	56	3.0	.053	95	4.6	.048	83	3.3	.040
$108,301 + ...	3	0.5	.155	1	.1	.118	3	0.5	.151
Total	59	3.5	.059	96	4.7	.049	86	3.8	.044

Source: Federal Home Loan Bank Board, Monthly Survey of Conventional Home Loan Mortgages.

Percent Distribution of Single-Family Conventional Loans Closed
(Figures in percent)

Loan Amount Distribution by Area	February 1983		June 1982		February 1982	
	No. of Loans	Total $ Amount	No. of Loans	Total $ Amount	No. of Loans	Total $ Amount
All area in U.S.						
Less than $108,301	92	80	94	83	92	78
$108,301 +	8	20	6	17	8	22
Total	100	100	100	100	100	100
High-cost area: San Francisco, CA						
Less than $108,301	73	58	77	64	75	59
$108,301 +	27	42	23	36	25	41
Total	100	100	100	100	100	100
Mid-cost area: Chicago, IL						
Less than $108,301	90	78	90	78	90	75
$108,301 +	10	22	10	22	10	25
Total	100	100	100	100	100	100
Low-cost area: St. Louis, MO						
Less than $108,301	95	86	99	98	97	87
$108,301 +	5	14	1	2	3	13
Total	100	100	100	100	100	100

SOURCE: Federal Home Loan Bank Board, Monthly Survey of Conventional Home Loan Mortgages.

Appendix B:
FNMA Links to the Federal Government

Federal Agency Security Status: Benefits

- U.S. Treasury line of credit of $2.25 billion;
- Eligibility of debt securities for Federal Reserve open market purchases and as collateral security for advances.
- Equal standing with Treasury debt for unrestricted investment by national banks and State FRB member banks.
- Eligibility as investments secured by real property (for national banks, S&Ls, MSBs).
- Eligible to collateralize public deposits (all Federal deposits, including Treasury tax and loan accounts; most State and local deposits).
- Eligible for investment by Federal Savings and Loan Associations, Mutual Savings Banks, Federal Credit Unions; meet conditions for S&L liquidity reserves when less than five-year maturities. Also eligible for fiduciary and trust funds under U.S. jurisdiction.
- Exemption of corporate earnings from State and local income taxes.

- Exemption from requirements for non-interest bearing reserves.

- Exemption from SEC registration and related accounting and disclosure requirements. (Avoids both direct expense and market costs of adverse information.)

- Immune from certain anti-trust constraints.

- Exemption from selected State banking laws such as restrictions on branching.

Federal Supervision and Controls

- Oversight of Congress.

- Treasury approval to issue debt (including securities).

- Board of Directors: five of fifteen Board members are appointed annually by the President.

- HUD specific and general regulatory oversight, including new program approval, establishing a debt-to-capital ratio, and approval of all securities and other debt and stock offerings.

- Agent for U.S. policy: The Secretary of HUD has specific authority to have FNMA provide "reasonable" support for low- and moderate-income residential housing while remaining a profitable enterprise.

- Budget status: Government-sponsored enterprise (off-budget).

Senator TOWER. Thank you, Mr. Kudlow.

Would removal of the SEC registration exemption be an appropriate move toward the privatization of FNMA?

Mr. KUDLOW. Well, it is something that we would certainly favor considering and discussing.

Senator TOWER. You mentioned that's one of the major aspects that make the private market less competitive.

Mr. KUDLOW. The development of the new shelf registration rules has reduced the cost of this quite a bit and I think makes this one of the more obvious candidates to be considered in any discussion of reducing linkages. Of course, along with that comes various issues related to SEC disclosure requirements and we would have to resolve that working with the agency and the SEC but I agree with you; I think that's one of the items we want to look at very carefully.

Senator TOWER. Now with regard to FNMA's request for additional asset powers, how would the administration respond to the idea of permitting the corporations acquiring financial institutions subsidiaries which could be separated from the agency benefits that are enjoyed by the parent corporation?

Mr. KUDLOW. Well, the notion of the so-called private subsidiaries that would not enjoy the same sponsorship as the corporation themselves is something that has been discussed by staff. I have discussed it. I think it's a constructive notion and something that ought to be carefully considered also. There are many ways to do that, Mr. Chairman. It covers a lot of ground. I referred in my testimony to some deregulatory tax changes we recommended. We are calling them TIM's [Trusts for Investments in Mortgages]. This may be an area to pursue with respect to the kind of private corporation subsidiary you're talking about.

In terms of acquiring private sector firms now in existence, I haven't really considered that as carefully. There are so few private sector firms in the secondary market area, but it would be something we would want to look at, yes, and it would also depend on the development of existing linkages between the corporation and the Government as to whether we would want to go the subsidiary route, but it may be a constructive avenue, yes.

Senator TOWER. You mentioned the TIM's proposal. Have you or has the administration calculated what the potential economic impact of that proposal might be on the private sector activity in the secondary market?

Mr. KUDLOW. Well, we are, fortunately and finally, coming to the end of our process of evaluating TIM's and have made a lot of progress on it just in the last few days. I can't give you at this point a satisfactorily comprehensive answer of quantitative support, but I can make some observations based on where we are.

We feel at the very minimum that these regulatory changes and tax changes that we are contemplating will attract a substantially larger volume of capital and credit from the private sector into the housing area. We feel that TIM's, if put together properly—and we think we have a pretty good plan—will create more instruments with more flexibility, tailored to the needs of a variety of investors—I might add, both large and small. So that the liquidity factor which is so important in the secondary mortgage market and which is regretably dominated now by the Government will be enhanced by these private securities. So that's the first step we've taken in our evaluation.

Now we are also exploring and investigating the impact on housing mortgage rates, for example. It would be our hope that more liquidity and better tailored instruments and more diversity in competition will be able to reduce the current cost structure and perhaps—and I say this more with hope right now than with firm analysis—but perhaps we can even cut mortgage rates. That has always been one of our desires, but I think without question we're going to improve the liquidity factor in that area and that's going to have a very favorable impact on the housing market overall.

Senator **Tower**. Thank you, Mr. Kudlow.

Senator Riegle.

Senator **Riegle**. Would you agree that the United States is probably the best housed nation in the world of any large size?

Mr. **Kudlow**. Well, I think, Senator, on a relative basis, that's true. Yes, I think you're right.

Senator **Riegle**. And I think that's an enormous accomplishment. I think you're right. I think we are and it's taken a lot of emphasis by the Nation and a lot of public policy initiatives to do that.

For example, we have the interest deduction on home payments as a tax writeoff. I don't know whether you have ever taken a position one way or the other in OMB on that issue, but—have you, by the way?

Mr. **Kudlow**. We have not.

Senator **Riegle**. Well, as you know, that issue or that policy has had an enormous bearing on our ability to house ourselves as well as we have.

I think the secondary mortgage market has also been an important contributing factor. Would you agree with that?

Mr. **Kudlow**. I would.

Senator **Riegle**. I would think the interest rate differential that you referred to earlier is one of the factors that has made housing available at somewhat reduced cost than would otherwise have been the case. That, plus a lot of other factors, has brought housing within the reach of a larger number of people.

Now we can argue whether that's a good use of capital or whether we're overhoused or underhoused. Dr. Feldstein thinks we're overhoused. There's a lot of difference of opinion on that issue. But I think you can trace the relationships and determine that the secondary mortgage market arrangements that we have had have been one of the contributing factors to why it is we are as well housed as we are today. Would you agree with that?

Mr. **Kudlow**. Well, I don't know that I would go that far, Senator, with respect to the discussion of the interest differential.

FEDERAL BORROWING LEAVES LITTLE FOR PRIVATE FIRMS

Senator **Riegle**. I noticed as you were showing Federal rate participation as a percent of domestic credit available that your table out through 1982 shows 48.9 percent, if I'm reading your table correctly. Is that right?

Mr. **Kudlow**. Right.

Senator **Riegle**. Is there a reason why you stopped at 1982? What do you project for 1983?

Mr. **Kudlow**. Well, we have estimates for Federal borrowing from the public. Obviously that's a budget aspect and we have some estimates for the Government-sponsored agencies that are given to us by those agencies themselves. We typically don't publish them because they are considered extremely rough.

Senator **Riegle**. Is there any reason to believe that by 1988, if we use the Reagan budget as projected out through 1988, that we might see that percentage go up as high as 60 or 70 or 80 percent?

Mr. **Kudlow**. Well, the answer to that is that it's possible the rate would go up.

Senator **Riegle**. What are the projections? I'm sure some projections have been done here.

Mr. **Kudlow**. If you turn to table 2, we have actually in this testimony published the estimates of the Government-sponsored agencies. We don't do it in the budget, but for purposes of this committee——

Senator **Riegle**. Let me tell you what I'm after to make sure in the time we have that you're responding to the question I have. I'm interested in the degree to which Government credit needs by 1988 are going to be taking a percentage of available credit in the country. That would be up in the range of 70 or 80 percent?

Mr. **Kudlow**. Well, depending on the outcome of the budget discussion, the short answer to your question is it is very possible. We have come in with this Government credit absorption or consumption from, in total, about 10 or 12 percent in the early and midsixties and we were running about 25 percent in the midseventies. Now we are running about 40 percent in the early 1980's. A lot of this, Senator—and I want to underscore this—a lot of the reason I'm concerned about the outyears is because we're learning that many of these credit demands are procyclical, not countercyclical. In other words, the expectations, for example of some of these agencies—look at FNMA and FHLMC, particularly FNMA—the first column in table 2, you can see that the estimates for 1983 and 1984 which average about $26 or $27 billion in borrowing, are substantially higher than 1982 and, of course, the earlier years. Now 1983 and 1984 estimates are based on some view of the recovery that is better than what we had in 1981 or 1982. I don't know what the internal recovery estimates are, but the housing situation is supposed to get better, and what they're saying, as a result of that, they are going to issue more debt.

Senator **Riegle**. Well, you expect that because this is actually procyclical. In other words, when housing comes back, you would expect this activity to go up, just as you expect unemployment compensation payments to go down as things turn around. But here's my concern. The best estimate that I have for the 7-year Federal deficit, 1981 to 1988, based on the Reagan budget as it's now in place—the program that we now have in the law and the requests that are on the table—give us a Federal deficit in the range of $1.1 trillion. Now that's everything. That makes this item become rather small as a percentage of the total, but when you look at the

$1.1 trillion that really makes me nervous and I assume it makes you nervous.

Mr. KUDLOW. It makes me very nervous.

Senator RIEGLE. A discussion of the effects on the Federal budget of this micro item by itself is substantial, but when weighed against a massive Federal deficit accumulation that we're piling on over this 8-year stretch, it shrinks down in size. I don't want to take it off the table. I want to leave it on the table, but I want to understand how you analyze the different credit needs in the Federal budget. If the secondary mortgage market financing requirements are alarming enough, how do we detach that from the larger discussion of the fact that we seem to be on the verge of using nearly all of the private savings pool? And if we're going to get up in the 70- or 80-percent area within a matter of years, it seems to me that's really an unworkable proposition, and I want to start with the larger picture and then work back to how this fits in. Do you share my concern?

Mr. KUDLOW. Yes, I do. Let me make two very quick responses and I hope I'm moving in the direction you want me to. If not, steer me elsewhere.

The first issue is this business cycle issue. You take the total sum of Federal credit absorption. The two largest growth areas are the Federal budget and the federally sponsored agencies. If the economy can grow in the next 5 years something near where the administration and CBO say it will, that's going to reduce the Federal deficit somewhat, not enough to suit everybody but at least you're going to run it down. So that's a plus.

On the other hand, if the economy grows similarly, federally sponsored agency borrowing is going to go up and it's going to offset the progress that we would get from the budget side. So that is a big concern.

We're running at cross purposes and that does concern me a lot. Indeed, that's one of the two issues.

PRIVATE FIRMS COULD BE MORE CREATIVE

Now, second, insofar as the credit for the housing area, which is vitally important, it's not obvious to me that this credit has to be absorbed or run through federally backed agencies. It could be available for private companies and private firms. Indeed, private firms might be more creative and provide better services to the home industry. In fact, it's interesting—you go back and look at the genesis of these agencies—take FNMA—I was informed in one of our reviews that in the Franklin Roosevelt administration, the first term of the Roosevelt administration, when housing was in very bad shape, the initial legislation and proposal from the Roosevelt White House was to invite in private sector firms to develop a secondary mortgage market, to put liquidity in that area. That's what they wanted to do. If my memory serves me, they had this proposal on the shelf to Congress for 4 years. I think from 1934 to 1938. Nobody came in. Nobody came in because the economic and financial situation was so devastating.

So what happened after that is they went toward the Government approach and they developed the Federal National Mortgage

Association. But it was not meant to dominate the market. It was only done at the time because they couldn't find any private firms.

Now today the situation is better and we could cross our fingers that this progress that we have made recently will go on and we have tremendous interest by private firms to get into this area.

So the only point I would make to you is I'm not convinced that we have to run the credit through the Government. I think at the very least we can open the way so the private sector has something to do here and we can run the credit both ways. By the way, if we do that right, you're going to reduce the Government borrowing burden to which you refer.

Senator RIEGLE. We still do not have the percentage that this credit demand represents of the total aggregate new credit demands of the administration's program, but it's a relatively small, modest percentage. That's not to dismiss it, but it is not what is driving up the deficit and draining the savings pool.

Mr. KUDLOW. You're quite right.

Senator RIEGLE. This system has worked pretty well and has matched private sector needs on both sides. Works as a conduit in the middle, but the net result is that housing opportunities have been really quite spectacular in this country over a period of years. The fact of the matter is, we are a very well housed Nation, and whether this is a perfect mechanism or not, it has had the effect of leaving us with the result that's been quite good. However, I don't think you can talk about either dismantling or changing in any fundamental way the secondary mortgage market credit system without relating it to the larger problem of rapid deficit accumulation.

So I want to be able to relate those things better and I think I have not heard that yet.

Mr. KUDLOW. Let me make a couple of comments on that. I'm not sure—at least personally I'm not convinced that we are doing the kind of job we could do in the secondary mortgage market area in terms of the impact on housing itself, housing starts and so forth. The biggest period of expansion for these federally sponsored agencies has come in the last couple years and it's not helped housing. It's not helped housing. Interest rates were just too powerful an influence. And so I worry about the borrowing from that standpoint. You can pour more and more credit in, but it doesn't seem to help housing, and there's a lot more to that analysis, but that one thing has to be said.

Second, with the housing agencies—the situation of FNMA is a perfect example. It got into a badly mismatched portfolio bind. That is not, I might add, a function of the current management who ameliorated the situation.

Senator RIEGLE. That is similar to what we see in the S&L business.

Mr. KUDLOW. Exactly. It was a cumulative problem over the course of many years and I think FNMA during the 1970's and early 1980's when this mismanagement developed would not have been able to issue the kinds of borrowing and debt, and expand its operations as it did if they had been subjected to the disciplines of the private marketplace. We would have seen earlier—we wouldn't have looked up in 1981 and 1982 and said, "Oh, my goodness, look what we've got on our hands." We would have seen it earlier. The market would have stopped us. We would have known earlier. So I think that's a problem, Senator.

Senator **Riegle**. What would that have done to the housing industry at that time? Would it have collapsed even further?

Mr. **Kudlow**. I don't know. It's hard to prove that. The agency stopped functioning anyway substantially, or the functions stopped. So I don't know what the value added was at that point. That's another issue.

The last point I want to make is I agree with you that at the bottom the system is working. I agree with you. And the issue here that we're raising—and I want to underscore this because there's some misunderstanding about it—we don't want any radical change right now. My priority is to keep the housing recovery going. I don't want to do a thing to hurt these agencies as they exist right now, including FNMA. What we are suggesting is a balance problem. We feel we are in a position now to make some small change as opposed to large changes to help the private sector get on track. I want to keep the public sector agencies for a while. Our view of this process is a long-term program. I don't want to do away with the Government-sponsored agencies. That would be unwise. It would be highly disruptive and would, in fact, damage the housing recovery.

What I'm saying is, however, rather than enable them to acquire more powers which will close out any possibility of future growth in the private markets, I would like to hold them where they are. I'd like them to continue to function with their present operations and their present charter, consolidate their financial positions and give the private sector some room to grow. If the public agencies want to move a little more in certain areas, then I feel they have the right to do so as long as they are moving toward the private sector so we have some fair competition. I think you don't want a situation 10 years from now when the housing agencies, especially in the mortgage finance area, is just a totally dominated Government industry. I don't think we want that. Nations whose capital markets are dominated by the governments are not as strong as ours.

Senator **Riegle**. My time is up.

Senator **Tower**. Senator Lautenberg.

Senator **Lautenberg**. Thank you, Mr. Chairman.

CONTINUATION OF HOUSING STARTS

Mr. Kudlow, obviously your views are for curtailment of the expansion of FNMA operations and you describe it as federally linked. What do you see right now in terms of the housing market? Do you see an expansion? You have projected this I'm sure. Do you see a continuation of the expansion of the housing starts that we have seen to this point?

Mr. **Kudlow**. Yes.

Senator **Lautenberg**. How long out?

Mr. **Kudlow**. Well, it's hard to say exactly, but I'll rely on our budget estimates with which you're familiar. We are looking for a long-term housing recovery. Housing starts are way up. We expect

2 million starts in the next 12 months. Now whether we can hold that or not remains to be seen and I'm not a housing forecasting expert, but I think if you're in the 1.7 million or 2 million area or let's just say the 1.5 million to 2 million range, that's a good, solid, long-term recovery rate and we hope to achieve that. But of course I have to tell you in all honesty and candor that some of my concerns about the borrowing and credit situation which I've heard from Senator Riegle raises a cloud over this long-term housing recovery. It raises a cloud.

Senator **Lautenberg**. It expands again the competition for capital that may be used for business investment. The cycling that we're talking about—you talked about the procycle and countercyclical activity here—we see projections of an expanded economy. You support those, I'm sure.

Mr. **Kudlow**. Hopefully.

Senator **Lautenberg**. Hopefully? You're part of the planning process for OMB and you support their projections?

Mr. **Kudlow**. I support the projections, Senator. I'm just saying that——

Senator **Lautenberg**. Would you like to do both, support them and not support them?

Mr. **Kudlow**. No. I support my projections. I have my fingers crossed that they will work out is what I'm suggesting. That's the point.

Senator **Lautenberg**. I think you put your finger on the problem before when you talked about the problem of big borrowing by Government generally and the extensions of Government borrowing as we see them and the very character of these agencies.

Not to get away from the housing track here, but I'll take the liberty of asking you how we are going to improve that credit situation unless that budget deficit is responded to in some way. I think that there is a lot of agreement out there that your curtailment of expenditures is a fairly difficult thing right now in all departments, yet on the revenue side there doesn't seem to be that urgency. That is, to close the gap by improving the income stream. Do you agree with that? Is that shaking your head just listening or is that agreement?

Mr. **Kudlow**. I'm listening, but, of course, in the President's budget we have a revenue measure, a substantial revenue measure which——

Senator **Lautenberg**. Substantial defined in terms of quantitative terms?

Mr. **Kudlow**. Well, I believe it's $45 or $50 billion in contingency tax triggered in 1986. That was the original proposal and I think the revenue projections rise from 1986 to perhaps $55 or $60 billion.

Senator **Lautenberg**. Triggered by further problems?

Mr. **Kudlow**. If the deficit is above 2.5 percent of GNP, that was the program we proposed, then this would trigger this contingency tax to deal with the situation you mentioned.

Senator **Lautenberg**. It puts a lot more pressure on, however, if that's required because obviously the budget deficit expansion becomes a more serious problem, and what I'm concerned about is I hear what you're saying and I'm inclined to agree that the Government ought to stay as far away from these programs as it can as long as the mortgage market is serviced—I agree with Senator Riegle's comments about the interest in housing in this Nation of ours, not only is it an important industry as we discuss here constantly, but also an important part of the American dream—but on one hand I see an economic program now that suggests that further deficits are going to be incurred because I think very frankly I don't see the interest in stimulating the revenue side of things here that is consistent with this concern about further expansion of Government credit. Maybe we ought to do, since you compare the FNMA securities with Government instruments—maybe what we ought to do is label them like they do in the FDA that this certificate or instrument in no way represents the full faith of the U.S. Treasury. But aren't we concerned about the same problem and looking at it in two different ways? I think that this is the tail and not the dog—and this has nothing to do with the chairman's pet project, but——

[Laughter.]

Senator LAUTENBERG. I thought that joke was better than that. [Laughter.]

But it is the end of the thing and not the beginning, and that is even if we're able—if we continue containing Government agencies or quasi-Government agencies in the housing market, it's a small problem in terms of the total budget deficit amid the problems we're facing.

Mr. KUDLOW. Small, but growing.

Senator LAUTENBERG. Well, I would urge that whatever influence you would have in terms of your recommendation that we try to stimulate the revenue side of things——

Mr. KUDLOW. Senator, if I might just make a brief comment. As you can guess, this is not the appropriate moment for me to raise any new initiatives on spending or revenue policies, but I will say this, that in terms of the broader problem to which you referred, the overall borrowing, as well as the narrower problem we are discussing on the federally sponsored agencies, I feel now and have that our hopes of economic growth in the 1980's, with low inflation and low interest rates and so forth, are good hopes and reasonable hopes, but this fiscal borrowing problem with all the financial market manifestations is our Achilles heel. It's our problem, it's Congress' problem and it's the Nation's problem. It's our Achilles heel and we must come to grips with it.

Senator LAUTENBERG. I agree with you but I think what's happening here is we are treating the tip and not the iceberg, very frankly.

There are lots of proposals around according to the sponsors to enhance and sustain the improvements you cite in the housing industry. I guess it's fair to say that you think we have too much assistance in the Federal arena to housing, both directly and indirectly. Is that correct?

Mr. KUDLOW. Well, I don't know that I'd say we have too much. I feel that there's a sufficient amount of housing related assistance in the budget, both with respect to spending programs and loan programs. My view is rather than cut back in the area to which I'm referring today, the loan area, the Government-sponsored enterprise area, I would rather keep things as they are, but I would not want to see additional expansion until we've dealt with this private sector balance problem that's such a concern to me.

I don't want to recommend at this point a major cutback beyond the administration's proposals and so forth. In the credit area, Government-sponsored agencies and loan guarantees which are not reported on the budget, we have sought really a policy of containment. We just feel that, OK, what's done is done, and we would not want any further expansion until we deal with this private sector area.

Senator **Lautenberg**. That's not what we get when we hear HUD testifying in terms of containing the programs at their present level. We hear a lot of talk about cutting back on them.

Mr. **Kudlow**. Well, again, I'm not undercutting our budget proposals. I'm saying I'm not here today presenting anything new on that. Of course, I support the budget program and that is our policy in the housing area. I'm merely referring to the credit area and the off-budget area which I'm responsible for.

HIGHER LEVEL OF MORTGAGES

Senator **Lautenberg**. Senator Riegle made a point earlier about the higher level of mortgages and the appeal for the private sector getting into that area and FNMA's expansion to $108,000. Is it not so that a lot of the expansion is coming in the more expensive housing? Do you have statistics relating to the cost of the units that are being built now in this new expansion?

Mr. **Kudlow**. I don't have all those data. I haven't looked into it in that much detail. I can make a few comments for perspective purposes.

I think obviously in a recessionary period as the one we've had, one would add to it that the upper income areas would survive better than the lower income areas. In terms of the volume of housing starts in the upper income area, I don't know. I'm sure it was greater than it was at the lower end, but I think it was way off from where it was in earlier times.

In terms of the housing market itself, the whole housing market, I think what we'll find in the recovery, if this housing recovery is sustained, is that the big volume is going to come in the middle area. That's where the bread and butter is—that's where the meat and potatoes typically are and I think the private sector would love to get involved in that area. As a counterpart example, the private mortgage insurance people, the PMI's, have gotten involved in the middle area and they've done quite well. So I think in terms of the secondary mortgage market financing operations, the principal reason it seems to me to go into the upper income area is simply to say that it hasn't been covered by the Government, but I think they're going to want to expand their horizons and again you will hear testimony from people who are directly involved in that.

Senator **Lautenberg**. You did make a comment that you thought the focus ought to be in the middle to lower range areas.

Mr. **Kudlow**. Yes.

Senator **Lautenberg**. And I thought that was an interesting comment.

Mr. KUDLOW. I think, Senator, in terms of the Government's backing of FNMA, presumably that will continue. Indeed, it will continue. But we ought to direct it. I mean, Federal assistance ought to go to those areas that need Federal assistance. And I would not think that upper income housing is an area in need of Federal assistance. So I think it would be inappropriate to move there.

Senator LAUTENBERG. My time is up. Thank you, Mr. Kudlow. Thank you, Mr. Chairman.

Senator TOWER. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

I, unfortunately, missed much of Mr. Kudlow's presentation. I'm very impressed by the paper you have here and I think it's very helpful.

You oppose 6 of the 11 proposals made by FNMA; is that correct?

Mr. KUDLOW. Yes.

Senator PROXMIRE. And as far as the present powers are concerned, did you have a more decisive position last year than this year, that you wanted a committee appointed to discuss these various things? You're not proposing any diminution in any of these powers that they have or opportunities they have; is that correct?

Mr. KUDLOW. Well, I don't today have a concrete view of which of these special powers ought to be removed or reduced because I think what we need to do is under some aegis—and I think the aegis of this committee or subcommittee would be absolutely appropriate—we ought to have a process, some kind of formal decisionmaking or advisory process to take the concept we recommended—that is, we can support some of these amendments so long as there are some steps taken.

Senator PROXMIRE. I understand that. What I'm looking for is some kind of deadline. It seems to me we're likely to just mosey along here and we always have so many things to do. This is a very busy committee. The chairman of this committee is very busy. He's chairman of the Armed Services Committee. We have a lot to do on the floor. Time gets away from us pretty fast and it seems to me that unless we have some kind of deadline for this group you suggest to meet to report and then some agenda implicit here, we're just not going to make any advance in any way in privatizing FNMA.

Mr. KUDLOW. Senator, having been involved in a lot of complicated negotiations in the last couple years, I think pretty well knowing the players involved in this from the various sides, we could sit down and in a week's time I think we could come back to this committee with very concrete proposals based on this FNMA approach, based on our views that it has to be supplemented with some reduction of linkages, including the other federally sponsored agencies and some of their key people. But I think in a weeks' time of arduous discussion we could come up with something very concrete and indeed that is what I had in mind. I didn't specify it, but I indicated I thought we could do it in a quick period, a week, maybe 2 weeks at the outside.

Senator PROXMIRE. Today is Thursday, the 5th of May. Do you think we could start on something like next Monday and report in 2 weeks?

Mr. **Kudlow**. With a mandate from this group, I would be enthusiastic in my efforts to work on that and we'd start immediately.

Senator **Proxmire**. Would you agree that some—it doesn't have to be that deadline, of course—but would you agree that some limited, finite deadline is going to be necessary if we're going to get any action on this?

Mr. **Kudlow**. Absolutely. The issue, as you implied, has festered long enough.

Senator **Proxmire**. Thank you.

Senator **Tower**. Senator Riegle.

Senator **Riegle**. I'm going to be as quick as I can, Mr. Chairman.

First of all, in terms of referring to our earlier conversation, I think we have a crowding out problem coming at us like a speeding train here and nobody has the answers, and I think you've been very candid today to say that you're concerned about it and describe it as an Achilles heel, and I am concerned about it. We still haven't pinned down the percent of the private savings that's going to be used up by the Government in the outyears, but I've seen estimates that show that by 1987 or 1988 government borrowings may be somewhere between 80 percent and 100 percent of the savings pool.

Have you seen any estimates that are in this range?

Mr. **Kudlow**. Yes, pending various policy outcomes, there's a wide range, but the answer is that estimate is inside the range that you and I know.

Senator **Riegle**. And as we look at this historic buildup on table 1, it's enormous—we've never been there before in modern times. This is a whole new ballgame for us, not to mention the foreign debt needs of Brazil, Mexico, and other nations.

What does the deficit look like for fiscal year 1983? What's the latest estimate?

Mr. **Kudlow**. Well, at this point, given the knowledge at hand, it will not deviate markedly, I think, from the estimates made by the administration in the April update which was very close to $200 billion.

Senator **Riegle**. About $200 billion?

Mr. **Kudlow**. That's a preliminary guess, but I think we will not deviate too markedly from it, given what we now know.

Senator **Riegle**. An analyses of monthly data on the deficits show it above $200 billion.

Mr. **Kudlow**. Well, I think on that score it depends how you measure it. If you measure it on a unified basis, I don't think so. I think we're pretty close. If, on the other hand, you measure it on the national incomes and products account basis, the shorthand for the GNP accounts from the Commerce Department, I think you're right.

Senator **Riegle**. In any case, $200 billion is likely for fiscal year 1983?

Mr. **Kudlow**. Unfortunately, it may be one of our more accurate predictions.

Senator **Riegle**. I wish we were wrong in this instance and it would be lower, but I'm afraid you're right.

On another issue, I understand that in California the average price of a new starter home is about $90,000. It's hard to envision, but that's what the California experience is. It's a different market condition than the rest of the country.

INDEXING SYSTEM THAT ACCORDS DIFFERENT MARKET AREAS

Given the current $108,000 mortgage limit, I'm wondering whether we need an indexing system or something to take into account different market areas. Should there be a regional yardstick or specialized market yardstick for areas like California?

Mr. **Kudlow**. Well, that's an interesting notion. I haven't thought about the notion of indexing. The general issue of the mortgage loan level is, our staff work indicates that the present level grant to FNMA is satisfactory and adequate by our estimates to cover about four-fifths of the whole market and, again, I think you really are left with just the upper income. Now, it is higher, I might point out, and this is important with respect to other Federal programs—it is higher than the FHA limit. The FHA limit is $90,000.

Senator **Riegle**. Thank you, Mr. Chairman.

Senator **Tower**. Senator Proxmire, do you have any more?

Senator **Proxmire**. No.

Senator **Tower**. Thank you very much, Mr. Kudlow.

Our first panel today consists of Mr. David O. Maxwell, Chairman and Chief Executive Officer of FNMA; Mr. Kenneth J. Thygerson, President and Chief Executive Officer of FHLMC; and Mr. John Tucillo, director, Center for Housing and Community Development Research of the Urban Institute in Washington, D.C.

Gentlemen, you may present your entire statement for the record or summarize it if you see fit. In either case, you may proceed as you see fit. We will hear first from Mr. Maxwell of FNMA.

STATEMENT OF DAVID O. MAXWELL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. **Maxwell**. Thank you, Mr. Chairman. I would like to submit my full statement for the record if that's satisfactory.

I am Chairman and Chief Executive Officer of the Federal National Mortgage Association. Mr. Chairman, the issues in this hearing are not complex. They do not involve restructuring of the secondary market, deregulation of FNMA or FHLMC, or recapitalization of a governmental corporation. For FNMA, these hearings raise one issue: Will the Congress back our single-minded dedication to housing by enacting some modest Charter Act amendments we badly need to insure our future ability to carry out our mission?

As a leading institution in the secondary market, FNMA has only one mission: To serve American housing. We serve all regions and all buyers, not just the most profitable parts of the market. We serve housing all the time, not just when housing happens to provide the most rewarding investment opportunities in a given year. FNMA is proud of its track record of support for housing, and I would like to use this opportunity today to talk about some of FNMA's recent difficulties in its efforts to serve housing, FNMA's self-help program for overcoming those difficulties, and the modest package of legislation that is the needed complement to this self-help program.

FNMA PLAYS VITAL ROLE IN AMERICAN HOUSING

When all is said and done, Mr. Chairman, these are among the heavy questions before this subcommittee in considering FNMA's proposed amendments: Will the Congress recognize the vital role this institution that you created plays in providing the funds for the housing the American people need? Are you willing to risk the future ability of FNMA to carry out its mission by denying to it the modest Charter Act changes it needs to carry out its unique mission? Do you really believe any other corporation, not dedicated to housing by law, policy, and business imperatives, will serve housing when times are tough as FNMA has done since Congress created it?

Mr. Chairman, I appreciate the concern you have expressed about the future role of FNMA and FHLMC in the secondary mortgage market and of the appropriate Federal role in sponsoring these institutions. We welcome your invitation that we start a dialog with the Congress on this subject. In fact, FNMA is currently devoting significant financial and managerial resources to a broad study of possible future alternatives for FNMA and the appropriate role of federally sponsored institutions in the secondary mortgage market. This study has made us acutely aware that a whole host of private financial institutions benefit from a variety of forms of governmental backing—some of which have a more direct effect on market access and borrowing costs than FNMA's Federal agency status.

And the most important thing to remember about our Federal ties is this: The trade-off for these ties is concentration on one business and one business only—housing. We don't buy toaster loans or domed-stadium loans when rates on those loans are higher than on housing loans—as they frequently are. We don't limit our business to the "best" housing loans in the "best" locations in the "best" years. That is not true of firms that are not subject to our Charter Act. I think it's very important to remember that we cannot, and do not and will not go into other businesses. We will not just limit our business to the best loans in the best locations in the best years.

Moreover, and I might say parenthetically, I appreciate the tone of Mr. Kudlow's testimony, but I feel that he has set up enough straw men to keep the other 12 witnesses waiting for the rest of the day. One of the things he said was that we are not subject to the discipline of profit, which is not the case. FNMA is in fact, and the Congress has deliberately imposed upon us, the need to be self-supporting and to raise our own capital to support our activities in the capital markets.

FNMA is in the market, buying housing loans year-in and year-out, in every city and town in America, with the only specific commitment of any private corporation in the secondary mortgage market in America to support low- and moderate-income housing. That's why Congress created FNMA. That's why FNMA exists. And that's why I respectfully submit, Mr. Chairman, the Congress should want to make sure FNMA will be strong enough to support housing all the time, especially in years like 1982 when we bought one of every six home loans in this Nation, and became known far and wide as "the only game in town" in the secondary markets.

I suppose one of the statements that Mr. Kudlow made that I take the most exception to, is that FNMA's activities in 1982 did not help housing. I think, Mr. Chairman, respectfully, if you ask any witness from the housing sector who will appear before you today, whether buying one in six housing loans in America helped housing in 1982, investing $15 billion in housing, I think that they will tell you that it helped a lot. And as I go around the country, and in your own State, Mr. Chairman, I think there are many builders and lenders who will tell you that they wouldn't be in business today if it were not for FNMA's activities in 1982. So I think Mr. Kudlow is a little off base in making that statement.

I think it's also well to remember the implications of Mr. Kudlow's position because the Congress will have to consider those very seriously when you turn to the consideration of the restructuring of the secondary market. That is, if FNMA is to be, in the words of the 1984 budget document, completely private, then, of course, we will not be necessarily involved with housing at all. We might build bicycles or we might do almost anything because, by their very nature, completely private corporations have the privilege of being in the business where they find the most profit.

Moreover, I do not believe that this is a budget question. Nothing in Mr. Kudlow's statement, in my opinion, substantiates any effect on the budget. And I think there's a lot of misunderstanding about this. FNMA's activities in the capital markets do not crowd out private borrowers any more than do the deposit-gathering and relending activities of banks and savings and loans which are federally insured up to $100,000. FNMA is a financial intermediary. Every dollar it takes out of the credit market in the form of debentures at discount houses goes back in the market in the form of a home loan. Like a bank or thrift, FNMA does not use the Nation's savings itself; it simply helps channel the savings into housing.

Of course, some argue that FNMA's assistance in the secondary market has helped the residential mortgage sector crowd out other demanders of credit, but the record does not bear this out. To the contrary, the residential mortgage market's share of total financial borrowing has grown in every single year since 1977. Furthermore, during that 5-year period, home loan borrowing has dropped by over 40 percent although other borrowing has risen by nearly 60 percent. The fact of the matter is, when rates are high, housing and not other uses is what gets crowded out, and FNMA, contrary to Mr. Kudlow's statement, is countercyclical. Our largest year in history in terms of mortgage purchases was in 1982, when we purchased $15 billion of mortgages and that was directly counter to the cycle that was existing and very important, Mr. Chairman. There were statements made and figures submitted—I don't know where they came from—but I can tell you that FNMA's borrowing in 1983 will be down sharply from what it was in 1982. Mr. Kudlow referred to a vast new expansion. There is no vast new expansion. As a matter of fact, FNMA borrowed $55 billion overall in 1982. That counts rolling over short-term debt, including $10 billion of entirely new money that wasn't used to pay off old debt. Issuance of $14 billion of mortgage-backed securities added up to a total of $69 billion.

In 1983, our expectations are that we will borrow $34 billion, down from $55 billion, including $4 billion of new money instead of $10 billion, and our mortgage-backed securities issuances will total about $10 billion rather than $14 billion.

The fact of the matter is that FNMA is countercyclical and that its activities do change, depending on the need for it. I might say, Senator Lautenberg, that our securities are clearly labeled that they are not guaranteed by the Government and they do not carry the full faith and credit of the Government behind them.

The fact is that FNMA is important, not so much for our average annual market share as for the substantial support for housing in difficult years when other investors leave the secondary market. Our average share of origination of mortgages is, over the life of FNMA as a private corporation, 6 percent and I think that's important to remember, because in a year like 1983, where there is plentiful money in the savings and loans and banks, much of the investment in mortgages by these institutions is being made for their own portfolios rather than selling them in the secondary market. Thus, when interest rates are stable and money for mortgages is plentiful, FNMA's share of the secondary market has run about 8 percent, as in 1976 and 1977, and that will probably be true for 1983. But when we're really needed, that share rises, as it did in 1982, to over 20 percent. And I submit respectfully, Mr. Chairman, that that's why we were created, and that we've been doing the job that Congress wants us to do.

It's extraordinarily significant for the housing market that FNMA buys so many mortgages for its own portfolio. In that respect, we are by far the largest portfolio investor, and one of the major matters that you can ascertain from the witnesses from the housing sector today is that that is a very important attribute of FNMA's activities.

By contrast, passthrough lenders not willing or able to purchase for portfolio tend to leave the market when their investors decide that other securities offer higher yields than mortgage-backed instruments. As a portfolio purchaser, FNMA has held billions of dollars of 30-year fixed-rate mortgages and financed them by shorter-term debt that must be rolled over many times during the term of the mortgage. This portfolio makes us extremely vulnerable to swings in interest rates. It cost us substantial losses totaling $295 million after taxes in 1981 and 1982.

In testimony earlier this year, Mr. Chairman, I shared with you and your colleagues in the subcommittee my frank report of

FNMA's grave financial jeopardy during the last 2 years. There are variables competing here. In mid-1981 FNMA was heading downhill at a rapid clip. The corporation had purchased only a little more than $1 billion in mortgages during the first 6 months of the year and losses were mounting fast—they would have reached $79 million in the third quarter of 1981. The cost of debt was rising. Market forces were forcing up the cost of our debt. But most of all, a continuation of business as usual was bringing closer the possibility that a FNMA insolvency could precipitate a financial crisis of historic proportion to this country.

In May 1981 the new management took charge, and knowing we did not control interest rates, we believed our only hope was to increase the yield on our assets and our fee income to offset the cost of our debt. We developed a strategy to do this and in the process provided unprecedented support for a nearly prostrate housing industry.

FNMA REMAINS VULNERABLE TO INTEREST RATE FLUCTUATIONS

Despite our progress, Mr. Chairman, FNMA remains vulnerable to interest rate fluctuations, due to the mismatch of its assets and liabilities. In the area of 11 to 40 years life; we have $34 billion of assets and about $1.5 billion of debt. That dramatically states the mismatch that does exist. We also have $67 billion of long-term, fixed-rate mortgages out of a total portfolio of $74 billion, financed with indebtedness that averages 2 years and 5 months.

This discussion of vulnerability is not academic. FNMA may have ultimate governmental backing, but so do many other financial institutions and indeed nonfinancial institutions. And who would have thought a few years ago that some of the leading banks and thrifts in this Nation would have to be rescued by Federal action? Once the problem comes, it's too late to wring hands over what might have been. Just so with FNMA, except the only merger partner for this private supporter of the housing market is the U.S. Government and the taxpayers would foot the bill.

We are working to correct this precarious situation, but it will take time and the support of the Congress to do so. That is why we urge you to enact now a few modest legislative changes to assure FNMA will be around the next time interest rates rise or short-term rates exceed long-term rates for more than a short period, and that is why every major credit group in the housing field is supporting our key proposals.

Now I would like, Mr. Chairman, to take a few more minutes to discuss those proposals.

We seek a limited package of amendments to help us carry out our self-help program to repair our balance sheet over the next several years. These are not major structural changes. They do not constitute deregulation. They are not in any sense recapitalization of a Government-controlled corporation. Some would accomplish limited and focused broadening of the types of mortgages in which FNMA invests and the way in which FNMA can provide financing for mortgages. Others would improve our efficiency in managing FNMA, while a third category would reduce the regulatory delays to which FNMA is now subject because of our statutory relationship to HUD.

Each of these amendments detailed in my written testimony and appendix is intended to help FNMA provide money for America's housing needs.

To help address the problem of FNMA's asset and liability mismatch, FNMA has proposed a limited and focused expansion of asset powers, including the opportunity to buy a small percentage of nonresidential mortgages closely related to housing and some residential mortgages with balances above the present mortgage limit.

FNMA's nonresidential mortgage activity will also directly support housing. In 1981 and 1982, lack of available funds caused many commercial projects, particularly shopping centers, smaller office buildings and small parks related to residential development, to be postponed or even cancelled. This, in turn, meant that developers were deprived of the important boost to home sales that these local amenities provide. By providing a market for loans on projects that serve residential areas, FNMA would encourage the construction of these projects, and also related additional home building. This authority would also enhance our important community development program.

Allowing FNMA to purchase residential mortgages that exceed the statutory loan limits, currently $108,300, will enable FNMA to carry out our role as a truly national provider of residential financing.

Mr. Chairman, I might note that in 1982, a year ago, when the committee reported out a bill which included a complete removal of the mortgage limits for FNMA and FHLMC, there was no opposition expressed from any quarter. At that time interest rates were 16 percent. Interest rates are down now and the housing market is looking more attractive than it was at that time.

There are parts of the country today where a significant portion of the housing market generates mortgages in excess of $108,300. This means that the statutory limits price middle-income home buyers out of the FNMA and FHLMC market. These are not, I should emphasize, upper-income people. These are middle-income home buyers. For example, a home with essentially the same physical attributes may sell for $135,000 in Washington, D.C., $144,000 in Minneapolis, and of course you've heard the figures on California. On average, the loan limits exclude from our market about 25 percent of the single-family mortgages originated in the United States in 1982. Of course, the committee has recognized and the Congress has recognized the higher cost of housing in areas in the FHA program.

PERMITTING FNMA TO PURCHASE LARGER MORTGAGES

Finally, permitting FNMA to purchase larger mortgages will enhance rather than detract from FNMA's purchase of smaller size mortgages. In 1982, the first mortgages purchased by FNMA had an average unpaid principal balance of $47,500, far below the statutory mortgage limits. Increasing the limits will permit FNMA to mix in a small volume of higher balance mortgages and ultimately will mean lower rates for home buyers because FNMA's improved balance sheet will give us access to funds at lower rates which can be passed on to home buyers. In addition, middle-income home buyers in high-cost areas of the country who are now paying higher interest rates on their mortgages over $108,300 because those mortgages cannot be sold to FNMA and FHLMC, will directly benefit because these higher balance mortgages will no longer require such high rates.

Limiting the purchase of mortgages over $108,300 to 20 percent of our total activity, as we have proposed, will leave plenty of room for other secondary market purchasers, yet permit us to serve home buyers of moderate incomes in parts of the country today where a significant portion of the housing market consists of mortgages in excess of $108,300.

In my testimony, Mr. Chairman, I have pointed out that giving FHLMC and FNMA this additional authority over $108,300 will not in fact take a substantial share of the market over that figure and will leave a large market for other private companies that wish to participate in it.

The second category of Charter Act amendments would permit FNMA to offer limited voting rights to holders of preferred stock and would expand the FNMA Board of Directors to a total of 18 members by adding three new shareholder-elected directors. These are essential changes to help us manage efficiently this large company for the benefit of those who invest their money in our business, as well as home buyers.

The third category of legislative proposals involves the regulatory framework of the current FNMA Charter Act to reduce unnecessary regulatory burden which directly affects the efficiency of the housing market and has done so in specific instances. While ensuring that FNMA remains accountable to the Secretary of HUD and to the Congress, FNMA proposes to change HUD's oversight of our activity. We propose to eliminate HUD's prior approval and substitute for that detailed and quantified annual reports to Congress by both FNMA and HUD on FNMA's activities in fulfillment of our Charter Act purposes. And I want to emphasize that we do in this proposal retain the oversight of HUD.

These are moderate proposals, all of them, intended to complement FNMA's own efforts to strengthen our balance sheet and to help us continue our service to housing. FNMA serves all the market without segmenting to serve only the most profitable parts that can only be done geographically. We serve the market all the time without leaving the market when there is more money to be made elsewhere. That's why the trade groups interested in housing are supporting this key proposal for limited and focused expansion of asset powers and the increase in mortgage limits. We've had a lot of constructive dialog with these groups and have modified some of our original proposals to take their concerns into account.

They know how important FNMA's financial soundness is to housing. They've gone through the last few years with us and want to be able to rely on us again when times are tough.

Finally, Mr. Chairman, I respectfully submit that it simply makes no sense to forget the recent past and what FNMA did for housing when the need was greatest. It makes no sense to suppose that any other private entity, not established for the specific purpose of supporting housing, will do the same work when the need arises again. It makes no sense not to seize this chance to make sure FNMA can do the job for America's home buyers in bad years as well as good. And with your help and our determination, we can and will remain strong enough to stand up for housing for people of moderate means all over this country in any economic environment.

Thank you for the opportunity to make this presentation, Mr. Chairman.

Senator TOWER. Thank you, Mr. Maxwell.

[The complete statement follows:]

Statement of

DAVID O. MAXWELL

CHAIRMAN AND CHIEF EXECUTIVE OFFICER
FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. Chairman and Members of the Subcommittee, my name is David O. Maxwell. I am Chairman and Chief Executive Officer of the Federal National Mortgage Association. Today's hearings are important because they begin to focus on an element essential to the current housing recovery -- the secondary market. At the same time the issues in this hearing are not complex -- they do not involve restructuring of the secondary market, deregulation of FNMA or FHLMC, or recapitalization of a governmental corporation. For FNMA, these hearings raise one issue: Will the Congress back our single-minded dedication to housing by enacting some modest Charter Act amendments we badly need to insure our future ability to carry out our mission?

As a leading institution in the secondary market, FNMA has only one mission: to serve American housing. We serve all regions and all buyers, not just the most profitable parts of the market. We serve housing all the time, not just when housing happens to provide the most rewarding investment opportunities in a given year. FNMA is proud of its track record of support for housing, and I would like to use this opportunity today to talk about some of FNMA's recent difficulties in its efforts to serve housing, FNMA's self-help program for overcoming those difficulties, and the modest package of legislation that is the needed complement to this self-help program.

When all is said and done, Mr. Chairman, these are among the heavy questions before this Subcommittee in considering FNMA's proposed amendments: Will the Congress recognize the vital role this institution that you created plays in providing the funds for the housing the American people need? Are you willing to risk the future ability of FNMA to carry out its mission by denying to it the modest Charter Act changes it needs to carry out its unique mission? Do you really believe any other corporation, not dedicated to housing by law, policy, and business imperatives, will serve housing when times are tough as FNMA has done since Congress created it?

Mr. Chairman, I appreciate the concern you have expressed about the future role of FNMA and FHLMC in the secondary mortgage market and of the appropriate federal role in sponsoring these institutions. We welcome your invitation that we start a dialogue with the Congress on this subject. In fact, FNMA is currently devoting significant financial and managerial resources to a broad study of possible future alternatives for FNMA and the appropriate role of federally sponsored institutions in the secondary market. This study has made us acutely aware that a whole host of private financial institutions benefit from a variety of forms of governmental backing -- some of which have a more direct effect on market access and borrowing costs than FNMA's federal agency status.

And the most important thing to remember about our federal ties is this: The trade-off for these ties is concentration on one business and one business only -- housing. We don't buy toaster loans or domed stadium loans when rates on those loans are higher than on housing loans -- as they frequently are. We don't limit our business to the "best" housing loans in the "best" locations in the "best" years. ¶ FNMA is in the market buying housing loans year-in and year-out, in every city and town in America, with the only specific commitment of any private corporation in the secondary mortgage market in America to support low- and moderate-income housing. That's why Congress created FNMA. That's why FNMA exists. And that's why I respectfully submit, Mr. Chairman, the Congress should want to make sure FNMA will be strong enough to support housing all the time -- especially in years like 1982 when we bought one of every six home loans in this nation and became known far and wide as "the only game in town" in the secondary market.

¶ One of the major purposes of our corporate planning is the achievement, over time, of the kind of financial health for FNMA that could permit us to function in the financial markets on the basis of the strength of our own balance sheet and profit history. But it would be folly to change our relationship to the government now.

As I will discuss more fully, the legislative changes we have proposed will assist FNMA in achieving that financial health. None of these amendments would in any way prejudice any future action the Subcommittee might want to consider respecting the federally sponsored secondary market institutions. On the contrary, they have only one aim -- to strengthen FNMA's ability to serve the housing needs of the American people. That is why every major trade group in the housing field supports the key elements of our program: moderately expanded asset powers and limited increases in the size of the mortgages we can buy.

There is little question that a healthy housing market is essential to economic recovery. The New York Times[1] recently documented how housing provides jobs in construction and in a host of supporting industries including lumber and other materials, transportation and trade, business services, and electrical and other equipment. Through multiplier effects, according to the article, this year's anticipated 1.44 million housing starts are expected to result in some $97 billion in sales and almost two million jobs.

Despite the American people's continuous need for housing, one aspect of the housing industry has been the periodic impact of economic cycles on construction and sales. Interest rates, the yield curve and the availability of credit all affect the vitality of homebuilding and home sales. Housing is crucially dependent upon the availability and affordability of residential financing, and residential financing in turn depends heavily on the secondary market. Indeed, with the likelihood that thrift institutions will be less inclined to take the interest rate risk implicit in holding long-term fixed-rate mortgages in portfolio, the secondary market will be even more crucial to housing in the coming decade than it was in the last.

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[1] "Who Gains When Housing Prospers?", New York Times, April 17, 1983, p. F-1.

FNMA is proud of its record as a consistent secondary market supporter of housing. From its creation until the end of 1982, FNMA has purchased almost four and a half million residential mortgages, over 80 percent of them FHA or VA, for its portfolio. Today, FNMA holds mortgages on one out of fourteen American homes. Yet, despite this large aggregate figure, in the past five years FNMA averaged only about 15 percent of the total secondary market in housing finance, including FHLMC, GNMA, and secondary transactions among primary lenders. FNMA is important not so much for our average annual market share as for our substantial support for housing in difficult years, when other investors leave the secondary market. This support of housing in good times as well as bad comes from FNMA's role as the only significant portfolio lender in the secondary mortgage market. Unlike secondary institutions that deal primarily in mortgage-backed securities, FNMA always remains in the market. By contrast, pass-through lenders not willing or able to purchase for portfolio tend to leave the market when their investors decide that other securities offer higher yields than mortgage-backed instruments.

In order to be able to continue to play this role, FNMA must remain strong and viable -- and repair the serious damage our balance sheet has suffered in the last few years. In this respect, our problems are strikingly similar to those suffered by savings and loan institutions during the same period. You responded to their problems in passing the Garn - St Germain Depository Institutions Act in 1982.

Because of our structure as a portfolio lender, FNMA, more than any other institution, succeeded in providing large added measures of liquidity to the mortgage market during the severe housing credit shortages of 1969-70, 1974-75, and most recently, 1979-82. At times, FNMA has been the only substantial secondary market lender. During the troubled months of 1982, for example, FNMA purchased $15.1 billion in mortgages for our portfolio and guaranteed another $14 billion in mortgage-backed securities (of which $11 billion were swapped for mortgage loans in the portfolios of thrift institutions and banks and used to provide needed liquidity for those institutions).

FNMA's continuing leadership is also reflected in its secondary market innovations. FNMA, along with FHLMC, standardized conventional mortgage instruments, underwriting procedures, and forms. FNMA has been a leader in serving a broad range of the building, lending and real estate industries in the financing of condominiums, planned unit developments, manufactured housing, large-scale site developments, mobile home parks, hospitals, and nursing homes. We have devised programs for serving small communities, small lenders, home builders, and older urban areas. FNMA instituted the purchase of second mortgages in 1981, when astronomical interest rates forced buyers to find assumable first mortgages and supplement them with seconds. We bought $1.6 billion in second mortgages in 1982.

FNMA has helped HUD to launch many of its new programs by providing a ready secondary market to finance them. For example, in 1978 FNMA bought more than 85% of the dollar volume of FHA graduated payment mortgages, thereby helping to establish this credit vehicle for first-time homebuyers.

FNMA has also been an innovator in opening new sources of financing for housing by making mortgage-backed securities more attractive to investors. Since inception in late 1981, FNMA has issued more than $18 billion in mortgage-backed securities. Last month, for example, Empire of America, a nationwide savings and loan association, successfully sold $345 million of its Florida, Michigan, New York and Texas loans in FNMA mortgage-backed securities representing a wide range of interest rates. All of this first public offering of FNMA securities by an entity other than FNMA was immediately purchased at favorable yields. This record shows FNMA's dedication to its Charter Act mission of support for housing. We serve the broad market, not just the most attractive parts.

FNMA has been able to serve as a consistent supporter of housing because of our role as a portfolio lender, recently supplemented by our ability to issue guaranteed mortgage-backed securities.

As a portfolio lender, FNMA has held billions of dollars of 30-year fixed-rate mortgages and financed them by shorter-term debt that must be rolled over many times during the term of a mortgage. Because of this portfolio, which is an important aspect of FNMA's service to housing, FNMA as an institution is extremely vulnerable to swings in interest rates. The net result has been substantial losses -- totalling $295 million after taxes -- in 1981 and 1982. Although FNMA did return to profitability in the first quarter of 1983, our financial prospects are clouded by the possibility that interest rates could rise once again. For example, an increase of 25 basis points -- just one quarter of one percent -- in interest rates charged for debentures FNMA must roll over within the next five years, would cost FNMA almost $450 million over that five-year period.

More than $42 billion of the mortgages in FNMA's portfolio today yield 10 percent or less -- 73 percent of these are FHA/VA loans, fully assumable single-family and long-term multifamily mortgages. FNMA's liabilities, on the other hand, have short maturities, averaging two years and five months. FNMA's maturity mismatch is striking. For example,

- maturing within 1 year
  -- $8 billion in mortgages
  -- $24 billion in debt

- maturing in 11-40 years

-- $34 billion in mortgages
-- $1 billion in debt.

Thus, FNMA's achievement of $15 million in profits in the first quarter of 1983, in contrast to a loss of $42.2 million in the first quarter of 1982, is an accomplishment that gives us considerable pride. It is another step in the steady but slow turnaround of FNMA from the darkest days of third quarter 1981, when we lost $79 million. This turnaround is attributable far more to the many changes we have instituted at FNMA than to the decrease in interest rates since the late summer of 1982. Indeed, one result of the interest rate decline has been prepayment of higher-yielding mortgages in FNMA's portfolio. The $15 million in the first quarter profits occurred despite interest costs for the quarter that exceeded mortgage portfolio earnings by $29 million!

Achievement of one quarter of positive earnings by no means represents a return to permanent financial health for FNMA, which remains extremely vulnerable because of the high volume of low-yielding mortgages and rapid turnover of its debt.

I wish to share with you our past and continuing self-help efforts to bring the company into longer-term financial health without having to turn to the federal government for special subsidies.

The first part of our strategy was a series of measures that served both FNMA and the housing industry.

As FNMA began 1982, we faced prospects of a severe erosion of investors' confidence. FNMA had just experienced the worst year in our history, an after-tax loss of $190 million. The housing industry was headed into its worst year since World War II, and FNMA was losing money at a rate of more than $1 million per business day.

We knew we could not control interest rates. Our only hope was to increase the yield on our assets to offset the costs of our debt. To do this we:

- acquired a record-breaking $15 billion in mortgages--nearly twice the level of mortgage purchases in 1980--and in the process provided mortgage funds for one out of every six home sales in this nation;

- substituted mandatory delivery commitments for optional commitments, so that optional commitments accounted for only 12% of total purchases--compared to 100% in 1980--and thereby provided a more reliable basis for decisions on the amounts and terms of FNMA's borrowing;

- moved beyond standard mortgage purchase approaches through our auction and daily "window" to negotiate purchase of

$7.7 billion of loans, including many "buy-downs," which proved incalculably valuable to builders coast-to-coast;

- earned over $300 million in fees in 1982--4 1/2 times the $68 million in fees in 1980;
- sought, where possible, to lengthen the term of FNMA's debt;
- added new mortgage products, such as adjustable rate and second mortgages, to diminish vulnerability to interest-rate risks by shortening our average asset maturity, while at the same time continuing to give far more support to newly originated 30-year fixed-rate non-government insured, or conventional, mortgages than any other secondary market institution; and
- successfully introduced FNMA mortgage-backed securities and issued $14 billion in 1982.

The result of these self-help measures is shown in our modest profit for the first quarter of this year. Yet, despite our progress, FNMA remains vulnerable to interest rate fluctuations due to the mismatch of its assets and liabilities. This is seen in FNMA's $74 billion portfolio of mortgage assets, of which $67 billion represents long-term fixed-rate mortgages, financed with relatively short-term indebtedness.

Now this discussion of vulnerability is not academic. FNMA may have ultimate governmental backing but so do many other financial institutions. Who would have thought a few years ago that some of the leading banks and thrifts in this nation would have to be rescued by federal action? Once the problem comes, it's too late to wring hands over what might have been. Just so with FNMA, except the only merger partner for this private supporter of the housing markets is the U.S. government -- and the taxpayers would foot the bill.

Mr. Chairman, let me state for the record today, as I did at the March 10 hearing of the Senate Banking Committee: FNMA was close to the precipice 18 months ago, and the harm to the U.S. financial system that would have resulted from our falling over it is simply unimaginable. The company has been saved, but we need the backing of Congress to make sure we never again impose such a risk on the American people.

To continue our service to housing, FNMA's corporate plan for 1983 and beyond is to build on the successes of 1982, to diminish our vulnerability to interest rate fluctuations, and to tap new sources of capital, including offshore investors. When appropriate for the market, FNMA will also rely more heavily on mortgage-backed securities as a means of limiting the rate of growth of our huge portfolio. In 1983, FNMA plans to:

- Reduce average maturity of assets, both by:
  - -- selling long-term, fixed-rate mortgages out of our portfolio; and
  - -- acquiring shorter-term assets, such as adjustable rate mortgages and second mortgages, along with traditional types of mortgages;
- Lengthen average maturity of debt by refinancing maturing debt and financing new purchases with longer-term debentures rather than shorter-term debentures or short-term notes.
- Reduce financial leverage (i.e. debt/equity ratio) to levels that imply less interest rate sensitivity, and ultimately less dependence on federal relationships.
- Increase fee income from guaranteed mortgage-backed securities and other sources to provide for a stable pace of future income not subject to rising interest rates.

Any change in FNMA's traditional role as a federally sponsored, privately owned enterprise in the secondary mortgage market can only come once our self-help efforts have resulted in long-term improvement in FNMA's balance sheet. (Of course, the federal government could correct FNMA's asset/liability mismatch virtually overnight by acquiring the company's low-yielding portfolio or explicitly guaranteeing its debt. However, such a costly solution would be unwise public policy, especially at this time of large federal budget deficits.)

The time for considering profound structural changes, such as phasing out FNMA's federal involvement, will come when FNMA has managed to protect itself against risks of future interest-rate fluctuations. We urge you to enact now those legislative changes we propose to assure FNMA's support for housing the next time interest rates rise, or short-term rates exceed long-term rates for more than a short period.

The Charter Act Amendments

FNMA seeks a limited package of amendments to help us in carrying out our self-help program to repair our balance sheet over the next several years. These are not major structural changes. They do not constitute deregulation. They are not in any sense "recapitalization" of a government controlled corporation. Some would accomplish limited and focused broadening of the types of mortgages in which FNMA can invest and the ways in which FNMA can provide financing for mortgages. Others would improve our efficiency in managing FNMA, while a third category would reduce the regulatory delays to which FNMA is now subject because of our statutory relationship to HUD. Each of these amendments, discussed in greater detail in the Appendix to my testimony, is intended to bolster FNMA's position as an effective provider of residential mortgage credit in the secondary market.

FNMA's ability to provide housing finance is constrained by FNMA's need to be a strong credit risk so that we can attract funds in the credit markets -- and do so at favorable interest rates.

The strength of FNMA's balance sheet and income statement, together with general levels of interest rates, determines what rates

FNMA must pay for our funds. When FNMA must pay more for money, as in 1981, we must require higher rates on the mortgages we buy.

To help address the problem of FNMA's asset and liability mismatch, FNMA has proposed a limited and focused expansion of asset powers including the opportunity to buy a small percentage of nonresidential mortgages closely related to housing and some residential mortgages with balances above the present mortgage limit. In making these proposals, we have the backing of every major trade group in our industry.

Allowing FNMA, as a small portion of its annual mortgage purchases, to purchase nonresidential mortgages on real estate serving the needs of residents of neighborhoods, subdivisions, and other housing developments gives FNMA limited access to higher-yielding and shorter-term assets. To the degree that this strengthens FNMA by making us less vulnerable to shifts in interest rates, it will allow FNMA to provide mortgage financing at more favorable rates. Nonresidential mortgage purchases limited to 10 percent of mortgage purchases for portfolio, when combined with purchase of ARMs and other shorter-term mortgages, will reduce FNMA's sensitivity to interest rates while assuring that FNMA remains overwhelmingly dedicated to housing and able to purchase additional types of mortgages, including FHA/VA loans.

Moreover, FNMA's nonresidential mortgage activity will directly support housing as well. In 1981-82, lack of available funds caused many commercial projects--particularly shopping centers, smaller office buildings and small industrial parks--to be postponed or even cancelled. This in turn meant that developers were deprived of the important boost to home sales that these local amenities provide. By providing a market for loans on projects that serve residential areas, FNMA would encourage the construction of these projects, and also related additional home building. This authority would also enhance our important community development program.

Allowing FNMA to purchase residential mortgages that exceed the statutory loan limits, currently $108,300, will enable FNMA to carry out our role as a truly national provider of residential financing.

There are parts of the country today where a significant portion of the housing market generates mortgages in excess of $108,300. This means that the statutory limits price middle-income homebuyers out of the FNMA market. For example, a home with essentially the same physical attributes may sell for $135,000 in Washington, D.C., $144,000 in Minneapolis, $225,000 in San Francisco and $325,000 in surburban Los Angeles. On average, the loan limits excluded from our market about 25% of the single-family mortgages originated in the United States in 1982.

Permitting 20 percent of FNMA's activities in mortgages that exceed the $108,300 limit will provide homebuyers all over the country access to FNMA's financing and will enable FNMA to offer primary lenders liquidity for a broader spectrum of residential mortgages they are making. As FNMA purchases these larger mortgages, primary lenders will finally be able to sell them in a functioning secondary market as an alternative to holding them in portfolio.

I should note that as a result of the proposed limit of 20 percent of FNMA's activities for mortgages exceeding the statutory limit, FNMA's involvement would be limited to about 15 percent of that segment of the market.[2]

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[2] With a 75% loan-to-value ratio, the mortgage limit of $108,300 limits FNMA to mortgages on homes costing less than $145,000. (At 80% the limit affects homes above $135,375, and at 90% it affects homes above $120,333.) Assuming that the 75% ratio was average, approximately 25% of 1982 mortgage originations were over $108,300. In 1983 and 1984 FNMA expects this percentage to remain close to 25%. Based on Regional Data Associates' estimates, single-family mortgage originations are expected to reach at least $161 billion in 1983 and to be near $231 billion in 1984. Thus, the market in excess of statutory limits is likely to exceed $40 billion in 1983 and $57 billion in 1984.

FNMA's ability to deal in these mortgages in 1983 would be limited to 20% of its 1982 secondary mortgage market activity of $29.1 billion, or $5.8 billion. This would permit a maximum 1983 participation by FNMA in 14.4% of the estimated market for these mortgages. In 1983, we estimate FNMA's total secondary mortgage market activity at $37.5 billion (including the $5.8 billion in mortgages over $108,300). FNMA's ability to deal in such mortgages in 1984 would be limited to 20% of 1983 activity, or $7.5 billion. Thus, FNMA's maximum involvement in the market for these "non-conforming mortgages" would be 14.4% in 1983 and 12.9% in 1984, leaving approximately $34.3 billion and $50.2 billion of these higher balance originations for purchase by other market participants.

Finally, permitting FNMA to purchase larger mortgages will enhance rather than detract from FNMA's purchase of smaller sized mortgages. In 1982, the first mortgages purchased by FNMA had an average unpaid principal balance of $47,500, far below the statutory mortgage limits. Increasing the limits will permit FNMA to mix in a small volume of higher balance mortgages and ultimately will mean lower rates for homebuyers because FNMA's improved balance sheet will give us access to funds at lower rates which can be passed on to homebuyers. In addition, middle income homebuyers in high cost areas of the country who are now paying higher interest rates on their mortgages over $108,300 because those mortgages cannot be sold to FNMA and FHLMC, will directly benefit because these higher balance mortgages will no longer require such high rates.

Additional business-related amendments (1) would remove some restrictions on FNMA's ability to make loans on security of mortgages and would make such loans a means of providing secondary market liquidity where originators prefer to obtain financing without selling their mortgages, (2) would remove the current 80 percent loan-to-value restrictions for multifamily mortgages, and (3) would authorize FNMA to guarantee the mortgage-backed securities of others as an alternative means of financing. We believe all of these would facilitate the flow of funds to housing.

The second category of Charter Act amendments would permit FNMA to offer limited voting rights to holders of preferred stock and would expand the FNMA Board of Directors to a total of 18 members by adding three new shareholder-elected directors. These are essential changes to help us manage efficiently this large company for the benefit of those who invest their money in our business, as well as homebuyers.

The third category of legislative proposals involves the regulatory framework of the current FNMA Charter Act. In 1970, when FNMA was first given conventional mortgage authority, Congress was concerned about the implications of authorizing conventional mortgage activity. Congress required FNMA to obtain prior approval of the HUD Secretary for FNMA's conventional mortgage activity and, as Congress added new authority, it required prior HUD approval in each case.

HUD has chosen to interpret this approval requirement in a non-generic way, requiring FNMA to present for such approval new categories of conventional mortgage activities. This has led to significant delays in FNMA's ability to respond to mortgage market needs and opportunities. Now, 13 years later, FNMA has a solid track record of support for housing and of careful underwriting to assure sound mortgage purchase decisions. The purpose of the prior-approval requirement seems to be long gone.

To reduce this unnecessary regulatory burden, while assuring that FNMA remains accountable to the Secretary and to the Congress, FNMA proposes eliminating the prior approval and substituting HUD oversight and annual reports to Congress by both FNMA and HUD on FNMA's performance of our Charter Act purposes.

FNMA also proposes that Congress require the HUD Secretary to respond to requests for action under the Charter Act within a 45-day period, with a 15-day extension permitted. Finally, FNMA proposes that Congress delete HUD's authority to approve issuance of FNMA's obligations other than stock and debt convertible into stock. This is redundant to the present authority of the Treasury to approve FNMA's issuances of debt obligations, which would remain unchanged.

To assure accountability, FNMA intends that our annual reports to Congress and HUD be detailed and quantified. They would include careful reporting of each aspect of the corporation's support of housing, specifically focusing on the total dollar amount of the corporation's activities involving residential first and second mortgages, residential mortgages exceeding the principal-amount limitations, nonresidential mortgages, the proportion of FNMA's previous calendar year's mortgage purchases its nonresidential mortgages represent, and the proportions of FNMA's previous calendar year's mortgage purchases, loans on the security of mortgages, and mortgage-backed security activity, its larger mortgage and second mortgage activities represent.

FNMA would be required to report on each year's activities by March 15 of the following year, and the HUD Secretary would be required to make a report to Congress on FNMA's activities by April 15. This timing will give the Congressional oversight committees the opportunity to benefit from the reports and to reflect on their contents within the framework of the normal legislative cycle.

These are moderate proposals, intended to complement FNMA's efforts to immunize ourselves from continued vulnerability to the real possibility of failure, a possibility we experienced in 1981-82. That is why trade groups interested in housing, the National Association of Home Builders, National Association of Realtors, Mortgage Bankers Association, American Bankers Association, National Association of Mutual Savings Banks, and United States League of Savings Institutions, are supporters of FNMA's key proposals for limited and focused expansion of asset powers and an increase in mortgage limits. As a result of constructive dialogue with these groups, we have modified some of the details of our original proposals to take their concerns into account, and they now stand fully behind us. They know how important FNMA's financial soundness is to housing. They've gone through the last few years with us and want to be able to rely on us when times are tough again.

By contrast, some of the witnesses coming before the Subcommittee today have registered opposition to FNMA's legislative proposals. They express concern that the implicit federal government backing of FNMA and FHLMC prevents private institutions from purchasing mortgages and issuing mortgage-backed pass-through securities to the extent they otherwise could. It is hard to believe this contention in light of (1) FNMA's small share of total one- to four-family mortgage originations (excluding portfolio "swaps") ranging from below 3% to below 16% over the past decade; (2) our 8-9% share of the secondary market in years of stable interest rates such as 1976-77, as opposed to our larger share in years when we are really needed, with approximately 22% in 1982; and (3) the large size of the total secondary mortgage market, as evidenced by $10 billion in mortgage-backed securities outstanding from issuers other than FNMA, FHLMC, and GNMA.

I hope that this testimony today has shown why the housing trade groups are backing FNMA's key amendments: As mandated in our Charter Act, FNMA serves all of the market, without segmenting to serve only the most profitable parts economically or geographically. FNMA serves the market all the time, without leaving the market when there is more money to be made elsewhere, or when times are tough. (Please see the Appendix to this testimony for a graph illustrating how FNMA has been especially important to housing in recession periods when homeowners and the housing industry have needed our help the most.)

The housing cycle is turning up once again, and we all rejoice. Yet, as builders, real estate professionals, lenders, and others in the industry painfully know, the cycle may turn down again. Interest rates may rise and money for housing may become hard to come by.

If the Congress will give us the tools we seek in the pending legislative proposals, we can assure you that FNMA will be there to do the job for housing when it counts the most. These limited and focused amendments will not preclude on-going Congressional consideration of structural changes to the secondary market. They are needed right now to assure that FNMA -- which you have created for this very purpose -- can serve America's homebuyers in the future, as we have in the past.

Passage of the legislation we propose will never hobble the secondary market. Even as we meet today, that market grows more varied and creative. This year, FNMA's share of a larger market than 1982 will probably not exceed one-half of our share in that year, when others dropped out.

I respectfully submit, Mr. Chairman, that it simply makes no sense to forget the recent past and what FNMA did for housing when the need was greatest. It makes no sense to suppose that any other private entity, not established for the specific purpose of supporting housing, will do the same work when the need arises again. It makes no sense not to seize this chance to make sure FNMA can do the job for America's homebuyers in bad years as well as good. With your help and our determination, we can and will remain strong enough to stand up for housing for people of moderate means all over this country, in any economic environment.

Thank you for the opportunity to present FNMA's legislative proposals today. I will be pleased to answer your questions.

1983 PROPOSED AMENDMENTS TO THE FNMA CHARTER ACT

- Asset Powers: To permit FNMA to purchase nonresidential mortgages serving the needs of residents of subdivisions, neighborhoods, housing projects, or other residential areas; up to 10 percent (in the first year 5 percent) of the previous year's mortgage purchases by the corporation.

- Multifamily Loans: Loan-to-Value Ratio: To remove loan-to-value restrictions on FNMA multifamily mortgages.

- Mortgage Limits: To permit up to 20 percent of FNMA's annual secondary market activity to be in residential mortgages without dollar mortgage limits (percentage measured by previous year's activity).

- Loans on the Security of Mortgages: To remove over-collateralization requirement and term restriction on FNMA loans on the security of mortgages.

- Authority to Guarantee Mortgage-Backed Securities of Others: To permit FNMA to guarantee mortgage-backed securities issued by others (to allow more flexibility in FNMA's current program).

- Voting Rights for Preferred Stock: To permit FNMA to offer limited voting rights to holders of preferred stock.

- Board of Directors: To expand the FNMA Board of Directors to a total of 18 members by adding three new shareholder-elected directors.

- Powers of the HUD Secretary: To require both FNMA and the HUD Secretary to report annually to Congress on FNMA's activities under the Charter Act, including the extent of FNMA's activities involving first and second residential mortgages, nonresidential mortgages and mortgages that exceed statutory limitations, and FNMA's activities relating to housing for low- and moderate-income families.

- HUD Approval of New Mortgage Programs: To substitute HUD oversight and annual reports to Congress by FNMA and HUD for HUD prior clearance of new mortgage programs.

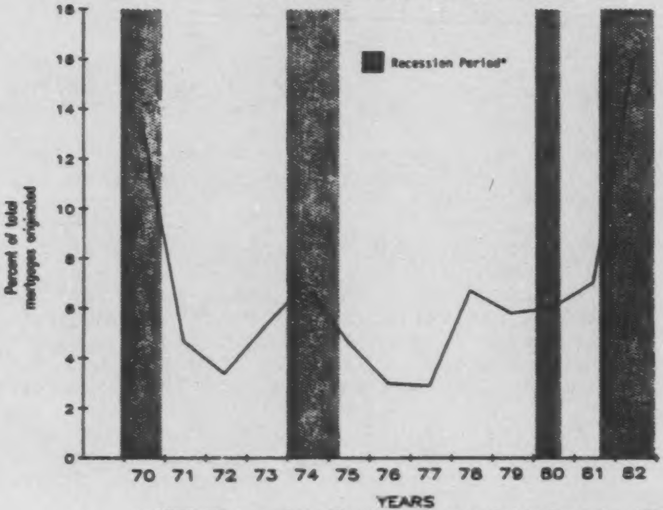
- HUD Authority Over Obligations: To delete HUD prior clearance of FNMA obligations other than stock and debt convertible into stock (and retain Treasury authority over FNMA debt obligations).

- 45-Day Approval Period: To require HUD to respond to requests for action under the Charter Act within 45 days, with a 15-day extension permitted.

PROPOSAL: Asset Powers: To permit FNMA to purchase non-residential mortgages serving the needs of residents of subdivisions, neighborhoods, housing projects, or other residential areas; up to 10 percent (in the first year 5 percent) of the previous year's mortgage purchases by the corporation.

BACKGROUND: Since 1969, FNMA has purchased 6.8 percent of all one-to-four family mortgage loans originated. Its support of housing has been even greater during the recession years of 1970, 1974, 1980 and 1981-82. In those times of high interest rates and reduced mortgage credit availability, FNMA has supplied nearly one out of every ten mortgage dollars borrowed in America:

FNMA'S COMMITMENT TO HOUSING
FNMA Purchases as a Percent of Total 1-4 Family Mortgages Originated



* 1981-82 recession estimated to have ended in December 1982

SOURCE: Office of Economics, FNMA

However, FNMA's ability to provide this type of needed support to homebuyers has been seriously jeopardized by its extreme sensitivity to interest rate changes caused by the maturity mismatch of the mortgages owned and the money borrowed to purchase the mortgages. FNMA's mismatch of very long-term mortgage assets funded with short- and intermediate-term liabilities produced unprecedentedly large losses during the high interest rate period of 1981-1982. Because of these losses some investors stopped buying FNMA debt entirely. FNMA's debenture costs were at times more than 100 basis points (one percent) above U.S. Treasury securities of comparable maturities, in contrast with a normal spread of 25-50 basis points. These higher borrowing costs meant that FNMA had to not only increase its fees but also raise its rates for buying mortgages. Moreover, FNMA's access to the 4-7 year debt markets was limited by investor concerns about its creditworthiness -- forcing FNMA to divert its borrowing into the even more mismatched area of one year and less and forcing the interest rate spread for those issuers to an unprecedented 200 basis points over comparable Treasury securities.

To avoid repeating this experience -- and to lessen its chance of ever having to call on the U.S. Treasury for assistance -- the corporation is attaching the highest priority to reducing its sensitivity to interest rates. As of March 31, 1983, FNMA held over $67 billion in long-term fixed rate mortgages, with an estimated average maturity of 13 years and an average yield of 10.41 percent. Over $38 billion of that total consisted of FHA and VA single-family and project mortgages with an average yield of 9.36 percent. These long-term fixed rate mortgages were funded with discount notes and debentures having an average maturity of 2 years 5 months, and an average cost of 11.19 percent.

FNMA's primary strategy for dealing with this mismatch has been to initiate a "self help" program to emphasize fee income -- including the guarantee fees on its mortgage-backed security -- and to aggressively build a portfolio of "matched" adjustable rate mortgages. The rationale behind this strategy is that the volatile nature of FNMA's "mismatched" portfolio earnings can be partly offset by a significant flow of earnings that is not rate sensitive. This steady flow of "matched" earnings and fees will lower the perceived riskiness of the company, allowing it to borrow less expensively in the credit markets, post more competitive rates to home loan sellers, and expand its commitment to the housing market.

Nonresidential mortgage purchase authority would be a very important addition to FNMA's ability to produce steady, interest-insensitive income. A typical mortgage on a nonresidential property has a maturity of 4-7 years, which is precisely the range of FNMA's present debenture borrowing.

Both the amount and composition of FNMA's proposed nonresidential activity will complement its basic business of buying home loans. Nonresidential purchases at ten percent of total residential activity would be significant enough to make a difference on FNMA's income statement, yet small enough that FNMA's resources would remain overwhelmingly committed to supporting housing.

FNMA purchased $15.1 billion in home mortgages in 1982. Ten percent of that amount is $1.5 billion, and five percent is $750 million. If FNMA were to buy $750 million in intermediate-term nonresidential mortgages in the next year at 175 basis points over its borrowing costs -- a realistic spread in light of current market rates -- and $1.5 billion per year the next two years, this relatively modest portfolio of $3.75 billion would yield $41 million in "matched" pre-tax earnings in 1986. Coupled with anticipated adjustable rate mortgage purchases and mortgage-backed security fees, this would give FNMA close to $300 million in matched portfolio and guarantee fee income -- and would serve as a formidable buffer against market-induced earnings swings from mismatched residential lending.

Even so, FNMA's presence in the nonresidential market would be surprisingly small. Annual purchases of $1.5 billion would be less than four percent of estimated new nonresidential originations over the next three years, and even a $3.75 billion portfolio would be well under two percent of total outstanding nonresidential mortgage debt.

The markets for commercial real estate and housing are closely related. In 1981-82, lack of available funds caused many commercial projects -- particularly regional shopping centers and office buildings and industrial parks in non-primary markets -- to be postponed or cancelled. This in turn meant that developers were deprived of the important boost to home sales that these local amenities provide. By providing a market for loans on projects that serve residential areas, FNMA would encourage the construction of these projects and also related additional home building. This authority would also enhance FNMA's important community development program.

Granting FNMA this limited authority to purchase non-residential mortgages will not dilute its ability to serve the residential housing market. Prior to the debut of its mortgage-backed security, FNMA was able to buy only as many loans as it could actually hold in portfolio, as determined by leverage considerations and the investing capacity of its traditional debt holders. As these constraints were approached, any loan FNMA purchased which was not a home loan would come at the expense of one that was a home loan. However, this potential trade-off is not a consideration with the mortgage-backed security. Through its ability to "pass through" home loan purchases to the capital markets, FNMA's mortgage-backed security allows it to bid on mortgages without regard to portfolio capacity. As a consequence, FNMA's support of the residential market has now become dependent not on its portfolio capacity but rather on the rates it is able to offer to loan sellers. It is in this sense that broader asset powers should actually increase FNMA's support for housing. By helping to stabilize FNMA's income and reduce its market risk, this new authorization will allow FNMA to borrow less expensively in the credit markets, and by passing this advantage on to homebuyers make a greater volume of home financing both available and affordable.

CONCLUSION: To ensure its solvency in future high rate periods -- when its ability to help the homebuyer will again be urgently called upon -- FNMA must now begin to reduce the maturity mismatch between the mortgages it owns and the debt used to finance them by aggressively acquiring shorter-term mortgages and to build its sources of fee income. Purchasers of FNMA debt make decisions as to whether to invest in FNMA debt securities at all and what interest rates to require, on the basis of their evaluation of FNMA's financial strength. The purchase of nonresidential mortgages, whose maturities or rate adjustments can be closely matched to FNMA's borrowings, would play an important role in reducing FNMA's vulnerability to interest rate swings that otherwise might leave the company unable to carry out its primary mission of serving housing.

PROPOSAL: *Multifamily Loans: Loan-to-Value Ratio:* To remove loan-to-value restrictions on FNMA multifamily mortgages.

BACKGROUND: FNMA's Charter Act requires that the loan-to-value ratio of a conventional mortgage FNMA purchase not exceed 80 percent, unless the amount over 80 percent is covered by mortgage insurance or the lender retains a participation of at least 10 percent or agrees to repurchase the mortgage on default. Mortgage insurance is commonly available for conventional mortgages on one-to-four family dwellings, but it is not widely offered for mortgages on multifamily dwellings. Lender participations and repurchase agreements are generally not flexible alternatives for multifamily mortgages. Only one of the 15 private mortgage insurers offers insurance for multifamily mortgages, and its experience has not been profitable.

The 80 percent restriction also impedes FNMA's ability to give firm long-term take-out commitments for the purchase of multifamily mortgages. The demand exists for long-term commitments (ten years or more) as a means of redeeming bonds issued by state and local housing finance agencies and used to finance multifamily mortgages that have a term longer than that of the bonds. FNMA's commitment to purchase the mortgages at a future date assures that funds will be available to cash out the mortgage balance and pay off the bondholders. This is an important aspect of raising inexpensive money for multifamily projects. Since the loan-to-value restriction applies at the time of the purchase of a mortgage, FNMA's long-term commitments to purchase these mortgages must contain a condition that the loan-to-value ratio not exceed 80 percent at the time of purchase, some ten to twelve years in the future. Since certainty is desired in these transactions, the requirement serves as an impediment to this important means for FNMA to support multifamily housing.

The same problem exists for commitments in the one to two year range given to assure construction lenders that the mortgage can be sold to FNMA at the end of the construction period. These commitments too must be conditional and are therefore less effective. A decrease, however slight, in the value of the property that brings the loan-to-value ratio over 80 percent eliminates FNMA's ability to purchase the mortgage. FNMA believes that, by careful underwriting, it can adequately protect itself, without the formal constraints that result from the statutorily-imposed restriction.

CONCLUSION: The requirement that the loan-to-value ratio on multifamily mortgages not exceed 80 percent precludes FNMA from providing permanent financing for many projects that are financially viable and would provide much needed rental housing units. The statutory bases for exceeding 80 percent--private mortgage insurance, repurchase agreement with the originating lender or 10 percent participation in the mortgage by the original lender--are not feasible alternatives for multifamily mortgages. An inflexible loan-to-value standard also limits FNMA's ability to provide long-term commitments in connection with bonds issued by state and local housing finance agencies.

FNMA will soon begin a revised conventional multifamily mortgage program. With the removal of the current maximum 80 percent loan-to-value restriction, this program would help foster the production of much needed rental housing units. Given adequate flexibility, the conventional multifamily mortgage program could be a major activity of FNMA throughout the remainder of this decade.

PROPOSAL: Mortgage Limits: To permit up to 20 percent of FNMA's annual secondary market activity to be in residential mortgages without dollar mortgage limits (percentage measured by previous year's activity).

BACKGROUND: FNMA's purchases are currently constrained by a statutory mortgage limit of $108,300 per mortgage; the effect is to deny secondary market access to homebuyers in high cost areas of the country. As a result, homebuyers requiring conventional mortgage financing above FNMA's mortgage limit must pay a premium in higher mortgage interest rates compared to those paid by purchasers of similar homes in lower cost areas. This premium is a direct result of the inability of mortgage originators to sell these loans into the FNMA/FHLMC secondary market.

Prices for comparable homes vary significantly from area to area. For example, a home with essentially the same physical attributes may sell for $81,000 in Salt Lake City; $135,000 in Washington, D.C.; $144,000 in Minneapolis; $225,000 in San Francisco and $325,000 in suburban Los Angeles. Similarly, the same home would cost only $58,000 in a lower cost area such as Akron, Ohio; $63,000 in Birmingham, Alabama and $75,000 in Colorado Springs. These cost differentials reflect many factors--land and labor cost, local demand for housing and cost of materials--but not the cost of financing.

Assuming an average loan-to-value ratio of 75 percent, the FNMA/FHLMC statutory limit would exclude FNMA and FHLMC from the market for mortgages used to finance houses costing $145,000 and over. Sales at $145,000 and over were approximately 25% of existing home sales in 1982. Thus, one quarter of all housing finance involved "non-conforming" mortgages, i.e., mortgages that exceeded the FNMA/FHLMC statutory limits.[1]

Homebuyers seeking a mortgage in the high cost areas are faced with an additional burden: they can elect to invest a substantial portion of their savings as a down payment, to finance their homes with both a first and a second mortgage, or to pay the higher interest rate required for a loan that is not readily salable by the originating lender into the secondary market. This higher cost is caused not by a choice of life style but rather by the circumstances of living in a high cost area. The penalty is the interest rate risk premium the originator charges for a loan that must be held for its full term or sold in the very limited secondary market now available for such loans.

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[1] In 1982 homes selling for $120,000 and over represented 34.5 percent of total dollar sales, while those over $140,000, $160,000 and $180,000 respectively represented 26.8 percent, 19.1 percent and 15.3 percent of the market.

The premium being charged for higher-amount conventional loans (in the range of 1 to 1.5 percent) is not a function of loan quality, but rather a reflection of the "portfolio risk" these loans represent since they are illiquid. Without top quality credit guarantees or over-collateralization, both Standard and Poor's and Moodys specifically require that only loans at or below FNMA/FHLMC limits may be included in the mortgage-backed securities they will evaluate. However, the rating agencies do permit larger loans from Alaska or Hawaii, within the higher FNMA/FHLMC limits for those states. Therefore, it is not the size of the loan per se, it is its liquidity as judged by the FNMA/FHLMC limit that determines its acceptance in the capital markets. Increasing FNMA's limit will demonstrate the confidence of the secondary mortgage market in these loans and provide a more effective link between the demand for housing credit and the broader capital markets. In the final analysis, homebuyers will be the ultimate beneficiaries since the cost of home financing will be reduced and artificial price barriers to the credit markets removed.

In the Housing and Community Development Act of 1980, the Congress recognized this phenomenon with respect to the FHA program and authorized the Secretary of HUD to increase the FHA mortgage limits in high cost areas, thus providing homebuyers in the high cost areas access to the FHA program. For example, the FHA limits in the high cost areas indicated above are at the maximum, whereas in the lower cost areas the limits are well below the FHA maximum.

In 1983 single-family mortgage originations are expected to reach at least $161 billion, and they are expected to approach $231 billion in 1984 (based on Regional Data Associates' estimates). Assuming a 75 percent loan-to-value ratio, the dollar volume of mortgage originations in excess of the statutory limits in 1983 and 1984 is likely to remain close to 25 percent.

Based on the proposed 20 percent limitation, FNMA's 1983 activity in non-conforming loans would be limited to $5.8 billion (20 percent of FNMA's 1982 combined mortgage purchase and mortgage-backed security activity). Thus, even if FNMA did the absolute maximum permitted, FNMA's activity would involve only 14.5 percent of the dollar amount of 1983 mortgage originations over $108,300. Our estimates for FNMA's 1983 activity will allow FNMA 1984 activity in such non-conforming mortgages (measured as 20 percent of FNMA 1983 activity) of up to $7.5 billion, or 12.9 percent of the estimated total dollar amount of such non-conforming originations during 1984. This means that in 1983 other institutions will be looked upon to provide more than $34.3 billion for loans in excess of $108,300 and they will be asked to finance more than $50 billion of such mortgages in 1984. The effect of the limit on FNMA's authority to deal in non-conforming loans relative to the total amount of funds needed for loans above the statutory limits clearly demonstrates that FNMA activity in this market will not prevent others from participating.

CONCLUSION: Allowing FNMA to utilize a limited percentage of its purchases for loans above $108,300 will not only bring efficiency to that portion of the market, but will also remove an artificial barrier in the nationwide secondary mortgage market and demonstrate to the capital markets the investment quality of these loans. Thus, FNMA will be able to improve the distribution of capital available for home mortgage financing--a Congressionally mandated purpose of FNMA.

PROPOSAL: Loans on the Security of Mortgages: To remove over-collateralization requirement and term restriction on FNMA loans on the security of mortgages.

BACKGROUND: FNMA was given authority to make loans secured by home mortgages in the Housing Act of 1961. The authority was one long sought by the homebuilding industry and was expected to be used primarily by homebuilders. The program has not been used extensively because of its loan-to-value and term restrictions.

During high interest rate periods, many builders must take back mortgages on the homes they build and sell. This financing removes needed capital from the industry. Lending institutions with mortgage portfolios also often need liquidity sources during such periods. Secured loans are frequently the preferred means for obtaining this liquidity. Less restrictive requirements for FNMA loans on the security of mortgages will provide lenders and builders a source of liquidity for loans in lender portfolios and for builder-held mortgages and permit them to use the proceeds to finance the construction of new housing when it is most needed. For example, during the high interest rate period of 1981 and 1982, lenders and builders requested that FNMA activate its program to make loans on the security of mortgages -- yet, the limits of the program have prohibited its effective use by all but a few builders. Because of the statutory constraints on FNMA's lending authority, thrift institutions were required to swap their mortgages for pass-through securities, which they used to obtain liquidity in the "repo" markets.

FNMA's regular purchase program permits FNMA to purchase 100 percent of a mortgage that meets its regular purchase criteria. Nonetheless, loans on the security of mortgages are limited to 90 percent of the value of the mortgages securing the loan and restricted to a one year term, any renewal being limited to one year. Thus, FNMA's ability to offer attractive financing terms for loans secured by mortgages FNMA can purchase directly is constrained. This means of financing mortgage lenders is far less attractive than outright sale to FNMA, despite other factors that might make secured borrowing more desirable.

Removal of the loan-to-value and term restrictions will permit FNMA to offer liquidity to mortgage lenders on comparable terms both through purchase and through loans on security of mortgages -- thus enabling FNMA to provide lenders with liquidity in the way that best suits the lenders' needs.

CONCLUSION: Allowing FNMA to provide liquidity to the mortgage markets by making loans on the security of mortgages on terms comparable to those it now uses to provide financing by purchasing mortgages will provide builders and the housing industry access to secured lines of credit, thereby freeing investment capital for additional housing activity.

PROPOSAL: Authority to Guarantee Mortgage-Backed Securities of Others: To permit FNMA to guarantee mortgage-backed securities issued by others (to allow more flexibility in FNMA's current program).

BACKGROUND: In 1968, the Congress authorized the Government National Mortgage Association (GNMA) to guarantee mortgage-backed securities issued by others (section 306(g) of the GNMA Charter Act). Since 1968, GNMA has guaranteed the timely payment of principal and interest of over $150 billion of mortgage-backed securities (backed by FHA/VA mortgages), which were issued by approved lenders -- not by GNMA itself. The administrative/legal mechanism by which GNMA guaranteed the securities of others has proved to be highly efficient, thereby reducing transaction costs that would otherwise have increased the interest charges ultimately borne by the American homebuyer. Since November 1981, FNMA has issued more than $18 billion of FNMA's guaranteed mortgage-backed securities. The Charter Act currently requires that FNMA own the mortgages it places in securities. FNMA purchases these mortgages, paying for them either with cash or with its mortgage-backed securities.

This authority would permit FNMA to guaranty mortgage-backed "pay-through" bonds, a financing vehicle which some builders would prefer, mortgage-related bonds issued by state and local housing finance agencies as well as mortgage-backed "pass-through" securities issued by lenders.

The proposed amendment permits state regulated institutions (until June 30, 1985) to hold the FNMA guaranteed securities (and FNMA mortgage-backed securities issued under section 304(d) of the FNMA Charter Act) to the same extent that they are authorized to hold or invest in obligations issued by or guaranteed as to principal and interest by the United States or a U.S. agency or instrumentality. This will give FNMA the two-year period to obtain the appropriate approvals from state authorities. This is substantially identical (including the June 30, 1985 deadline) to provisions in section 306(e) of the FHLMC Charter Act with respect to mortgages, obligations, and securities sold by FHLMC.

CONCLUSION: The proposed FNMA amendment would create authority substantially identical to that of GNMA, except that FNMA's guaranty for securities issued by others, unlike GNMA's would not constitute an obligation of the United States or any agency or instrumentality thereof other than FNMA.

This authority would complement and simplify FNMA's current mortgage-backed security program, and would provide more alternatives for the financing of mortgages.

PROPOSAL: Voting Rights for Preferred Stock: To permit FNMA to offer limited voting rights to holders of preferred stock.

BACKGROUND: In 1982 FNMA was authorized to issue preferred stock on terms and conditions prescribed by its Board of Directors. The Charter Act now limits voting rights to common stockholders. This amendment would permit, but not require, the Board to provide such voting rights as it deems appropriate for preferred stockholders. (The FNMA common stockholders will be asked at their 1983 Annual Meeting to authorize the issuance of preferred stock on such terms and conditions as may be set by the Board, including the provision, should this proposed legislation be passed, of limited voting rights in the event of default in payment of dividends.)

The trend among corporations is to grant preferred stockholders limited voting rights in the event of an extended default in payment of their dividends. This trend is buttressed by the requirements of the New York Stock Exchange (NYSE), which may refuse to list an issue of preferred stock that does not contain certain limited voting rights. The NYSE requires, at a minimum, that preferred stockholders have the right to elect two directors if six consecutive dividend payments are missed by the corporation. The NYSE makes an exception only for those companies which cannot grant such rights under applicable state law.

Since the NYSE excepts from its general policy preferred stock of companies which cannot by law confer limited voting rights, the existing Charter Act provisions should not result in the NYSE's refusal to list FNMA's preferred stock. Nevertheless, since most companies grant limited voting rights to their preferred stockholders, preferred stock that does not have such rights is less acceptable to the markets, and purchasers would likely demand a higher preferred dividend rate than they would require if limited voting rights were offered.

CONCLUSION: Preferred stock is an essential source of equity capital that is commonly used by publicly-held corporations. This proposal will enable FNMA to better utilize the authority Congress gave it in 1982 to issue preferred stock as a means of augmenting its equity. It will enable FNMA to obtain equity capital from this source at a reduced cost, which FNMA will be able to pass on to homebuyers.

PROPOSAL: Board of Directors: To expand the FNMA Board of Directors to a total of 18 members by adding three new shareholder-elected directors.

BACKGROUND: FNMA has had a 15-person Board of Directors since 1968. Since then, FNMA has become both significantly larger (currently over $75 billion in assets) and more complex. Shareholder-elected directors are selected for their expertise in matters related to FNMA's business. With FNMA's plans to serve new mortgage customers and markets, and the need for new financing sources, there is a corresponding need for a larger, more diverse Board of Directors.

FNMA is not the only company that feels the need for a larger board. A 1981 survey conducted by the Financial Executives Institute indicates an average board size of 16 for financial services corporations, but finds that boards of such corporations with assets over $10 billion have an average of 19 directors. The survey generally found that as such companies get larger, in terms of asset size, the size of the Board increases as well.

A larger Board also relieves the burden on directors with respect to service on Board committees. As corporations become larger and more complex, they often experience expanded committee responsibilities and more frequent use of ad hoc committees.

It is appropriate to strengthen FNMA's Board by adding shareholder-elected directors rather than Presidential appointees, since the shareholders represent the entire financial investment in the company. The amendment gives the Board an opportunity to add three additional areas of expertise to its membership.

In addition, the value of Presidentially appointed directors has, regrettably, been diminished by their generally shorter terms in office. It takes some time for new directors to become familiar with FNMA, its operations and the issues facing it as a corporation. Longevity often provides valuable insights into FNMA's unique problems.

The FNMA directors are respectively elected or appointed for one-year terms. While shareholder-elected directors during the decade 1970-1980 served an average of just under six years on the board, Presidential appointees during this same period served an average of just under two years.[1] In fact, of the 24 Presidential appointees who served during this decade, only one served for as long as six years; one served for four years; and the rest served for three years or less. By contrast, five of the shareholder-elected directors served for the entire ten year period. Thus, it is the shareholder-elected directors that have given continuity to the Board.

Five Presidentially appointed members would continue to provide significant government representation. The percentage of the boards of Congressionally chartered, privately owned companies represented by Presidential appointees is not uniform. Governmental appointees are less than one third of the boards of several such companies, including Communications Satellite Corporation (Comsat), the National Consumer Cooperative Bank, and National Corporation for Housing Partnerships.

CONCLUSION: Enlarging the Board will strengthen FNMA's ability to serve the housing markets by increasing the diversity and expertise of the Board.

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[1] One director was not counted in this survey since he served both as a Presidential appointee and as a shareholder-elected director.

PROPOSAL: Power of the HUD Secretary: To require both FNMA and the HUD Secretary to report annually to Congress on FNMA's activities under the Charter Act, including the extent of FNMA's activities involving first and second residential mortgages, nonresidential mortgages and mortgages that exceed statutory limitations, and FNMA's activities relating to housing for low- and moderate-income families.

BACKGROUND: This provision is one piece of the proposed changes in the HUD/FNMA regulatory relationship. The Charter Act does not currently require FNMA to report regularly to Congress on its secondary mortgage market activities. Similarly, there is no statutory requirement that the Secretary of HUD report to Congress on FNMA's activities. While the Congress has access to information as a part of its oversight function, the proposed amendment will replace the patchwork of occasional oversight hearings and ad hoc reviews of isolated subjects, providing a systematic procedure for Congressional monitoring of FNMA's activities in support of housing.

CONCLUSION: This provision will establish an orderly framework for annual review of FNMA's secondary market activities by the Congress. FNMA and HUD will be required to present a comprehensive account of FNMA's performance of its Charter Act mandate. This will help assure that the nation's residential mortgage finance needs are being met, that demands are anticipated, and that any shortcomings are remedied.

PROPOSAL: HUD Approval of New Mortgage Programs: To substitute HUD oversight and annual reports to Congress by FNMA and HUD for HUD prior clearance of new mortgage programs.

BACKGROUND: Under the FNMA Charter Act, HUD approval is required for FNMA to engage in new conventional mortgage activities. This amendment, which is one piece of the proposed changes in the HUD/FNMA regulatory relationship, would insure FNMA's accountability by substituting HUD oversight and annual reports to Congress by both FNMA and HUD for this prior clearance requirement. The amendment would improve FNMA's ability to respond quickly to changing housing finance needs and to innovate in its mortgage activities without being subject to the delays inherent in the current HUD process. In today's mortgage market, with the reduced availability of low-cost, long-term housing credit and sometimes serious fluctuations in interest rates, homebuyers and mortgage lenders, who increasingly rely on FNMA and other secondary market investors, need a prompt response from the secondary market to changes in the market for housing credit.

The public need for new flexibility in residential credit is frustrated by the cost and delay of even the best intended regulatory review and approval. For example, a substantial amount of multifamily mortgage activity was lost to FNMA during the period September, 1982 - February, 1983, when HUD's review of FNMA's request for feasible multifamily authority was pending.

Moreover, HUD claims the right subsequently to amend or revoke authority it has already given FNMA and has placed a time limit on FNMA's second mortgage activity. Such "sunset" provisions and the possibility of subsequent change in authority frustrate FNMA's ability to plan effectively, presenting a very serious problem for effective business operations. In addition, lenders cannot commit significant resources, for example, in training staff and developing computer capacity, to engage in specific types of mortgage market transactions if they believe FNMA financing for the mortgages may become unavailable for reasons unrelated to market demand.

Needless confusion and uncertainty results from this piecemeal approach to regulatory approval. FNMA needs to be able to carry out its specialized functions without the delay involved in obtaining prior HUD approval of these activities. Experience over the years has shown that the fragmented, conditional approach HUD often takes to FNMA requests for approval merely frustrates the needs of the housing market. Innovation is delayed to no useful purpose and at needless cost to the ultimate housing consumer.

To a great extent, the statutory provisions for prior HUD approval are obsolete since FNMA has established a fine track record of sound underwriting and strong support for housing. In fact, FNMA's underwriting and loan standards are recognized as industry standards.

The highly specialized and technically demanding nature of FNMA's secondary mortgage market activities is ill-suited to the current regulatory review and approval process. Regulatory delay means that the market--the homebuyer--is deprived of a needed secondary market source of funds while the merits of a proposal are weighed.

CONCLUSION: The removal of the prior approval requirement would eliminate the continued possibility of long delays before FNMA can engage in future mortgage market activities and the uncertainty regarding future regulatory changes to approved programs. The provision for regular Congressional review of FNMA's activities will provide a more effective means of assuring FNMA's accountability, while allowing effective FNMA response to housing finance needs.

PROPOSAL: HUD Authority Over Obligations: To delete HUD prior clearance of FNMA obligations other than stock and debt convertible into stock (and retain Treasury authority over FNMA debt obligations).

BACKGROUND: This amendment is one piece of the proposed changes in the HUD/FNMA regulatory relationship. The Charter Act currently requires FNMA to obtain approval from both HUD and Treasury for issuance of its debt obligations and mortgage-backed securities. HUD regulations, currently in effect, authorize FNMA to issue debt obligations with the Secretary of the Treasury's approval but require FNMA to obtain prior HUD approval of "obligational authority."

Under this amendment, the regulatory authority of Treasury to approve issuances of FNMA's debt obligations and mortgage-backed securities and the authority of HUD to approve issuances of stock and convertible capital debentures remain unchanged.

CONCLUSION: This amendment would streamline the Charter Act by removing redundant provisions that potentially result in unnecessary expense and delay.

PROPOSAL: **45-Day Approval Period:** To require HUD to respond to requests for action under the Charter Act within 45 days, with a 15-day extension permitted.

BACKGROUND: This provision is one piece of the proposed changes in the HUD/FNMA regulatory relationship. The Charter Act authorizes FNMA, with the approval of the Secretary of Housing and Urban Development, to purchase, service, sell, lend on the security of, and otherwise deal in conventional mortgages. The Secretary's approval is also required for FNMA's issuance of stock and debt instruments. Although other proposed amendments would diminish the occasions when FNMA must obtain HUD approval, several matters would remain within the Secretary's regulatory jurisdiction.

In 1980, to avoid protracted delays in the implementation of the FNMA conventional mortgage-backed securities program, Congress specified that when FNMA submits a proposal to HUD and Treasury for implementation of mortgage-backed securities programs, the proposal must be approved within 90 days of the date of submission or a report must be transmitted to Congress explaining why such proposal has not been approved.

That provision (Section 330 of the Housing and Community Development Act of 1980) was instrumental in FNMA's obtaining prompt yet comprehensive review of its mortgage-backed securities program. Since November 1981, FNMA has issued over $18 billion of guaranteed mortgage-backed securities, which have provided new sources of funds for housing and increased liquidity to the savings and loan industry.

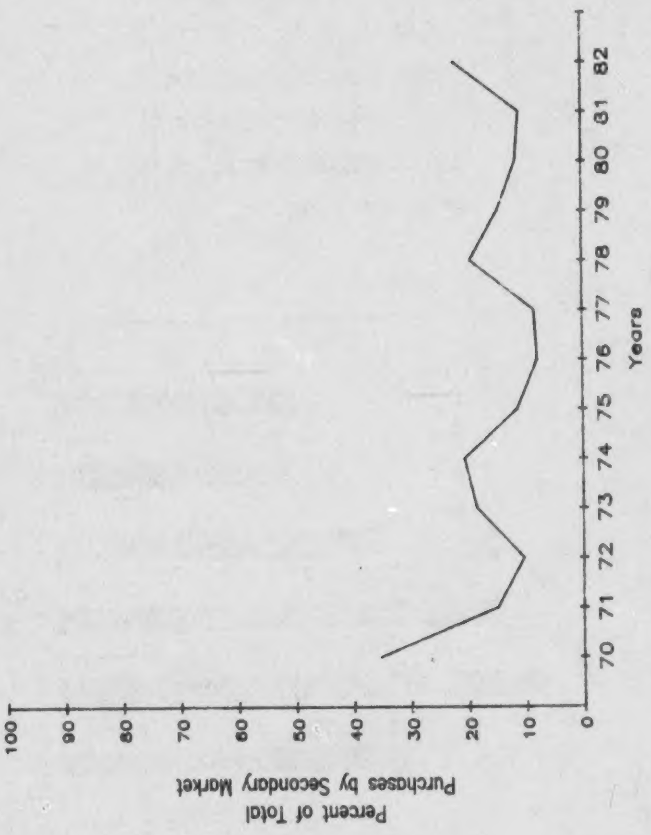
This amendment would supersede section 330, and subsections 339(a) (2) and 339(b) (2) of the Housing and Community Development Act of 1980 (which provide for a 75-day review period of FNMA home improvement and manufactured housing mortgage programs) and provide the Secretary of Housing and Urban Development a reasonable period in which to make appropriate determinations as required by the FNMA Charter Act. The 45 calendar day period, with 15-day extension if necessary, strikes a balance between the need of FNMA to make timely business decisions and the need of HUD to undertake an appropriate review of the FNMA request. If HUD fails to submit to Congress within the specified period, its reasons for disapproval of a FNMA request, the corporation may proceed as if the request has been approved.

CONCLUSION: This provision would enable FNMA to respond quickly and effectively to changes in the housing finance market and to implement its authorized mortgage programs as needed by the market. It would focus prompt FNMA and HUD attention on the important issues within the scope of HUD's regulatory authority and eliminate unnecessary costs due to unnecessary delay.

Statement by David O. Maxwell
Senate Subcommittee on Housing and
Urban Affairs

APPENDIX
ATTACHMENT I.

FNMA'S SHARE OF THE SECONDARY MORTGAGE MARKET



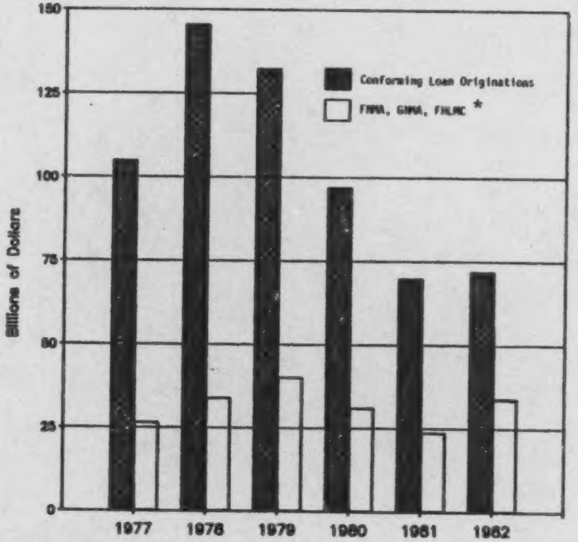
SOURCE: Office of Economics, FNMA

Statement of David O. Maxwell
Senate Subcommittee on Housing and
Urban Affairs

APPENDIX
ATTACHMENT II.

FEDERALLY RELATED AND "PRIVATE" PASS–THROUGH SUPPORT OF CONFORMING AND NON–CONFORMING LOAN ORIGINATIONS

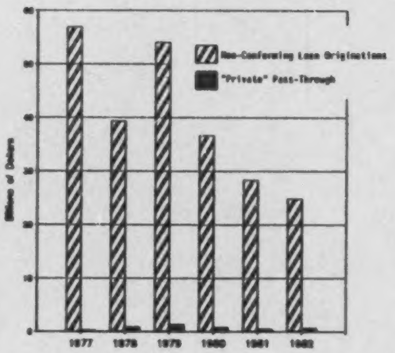
Conforming Loans



* Excluding swaps

SOURCE: Office of Economics, FNMA

Non–Conforming Loans



Senator TOWER. Mr. Thygerson.

STATEMENT OF KENNETH J. THYGERSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN MORTGAGE CORPORATION

Mr. THYGERSON. Thank you. Mr. Chairman and members of the committee, I appreciate this opportunity to testify on FHLMC's 1983 legislative proposals and other salient issues relating to the role of the federally sponsored secondary mortgage market corporations. I compliment the committee again for its careful review of our legislative requests.

As I see it, this hearing is really a continuation of congressional interest in the Nation's housing delivery finance system, a system which is undergoing great change. In my previous appearances before this committee, I provided evidence for why the secondary mortgage market has become one of the most important means of providing mortgage credit for home buyers, a position confirmed in your opening statement. I believe strongly that this country needs FHLMC and FNMA to insure that our Nation's mortgage credit needs and housing goals can be achieved.

Last month I highlighted the issues faced by Congress in reviewing the public policy role of the two national secondary market corporations. These issues generally fall into three categories: First, the extent to which Congress should provide broader powers to its secondary market agencies which go beyond their specialized function of assisting the development of and maintaining a national secondary mortgage market; second, the level of Government regulation and supervision over our activities, including the extent to which our favorable credit position in the capital markets is applied; and third, the issue of how we do business and in what structural form.

BROADER OPERATING POWERS

With respect to broader operating powers, we believe that it is entirely appropriate for the managements of private stockholder-owned Government corporations to request a wide range of operating authority both to fulfill their public policy purposes and to respond to their fiduciary responsibilities to stockholders. However, any request for broader powers must be evaluated by this committee in relation to the public policy objectives of the secondary market corporations as represented by over 40 years of legislative history.

This legislative record suggests that the use of agency status and the special advantages that go with it should be reserved for those entities that are not, or for some reason cannot be, adequately performed by the private sector.

We feel that the public purposes to be served by these activities are just as important today in the secondary market as they were 40 years ago and, indeed, there is data to suggest that they are more important now.

One of the issues this committee is being asked to consider is whether the special advantages granted to these Government corporations should be extended into markets that do not relate to providing a secondary market for residential long-term lending.

Should Government-sponsored corporations be able to use their special borrowing advantage beyond their specialized function to compete against private companies in the same business that face higher borrowing costs, not because of bad management or weak financial positions, but merely because those companies do not have an "agency" borrowing status?

We believe any discussion of new or expanded powers for federally chartered secondary market corporations can be categorized in one of three ways:

First, those enhancing the ability of Government-sponsored corporations to fulfill their current specialized function of assisting the continued development of a national secondary mortgage market, to support housing.

Second, those powers which would expand the current specialized function to allow involvement in real estate related areas.

Third, those powers which would expand the specialized function of these entities to allow involvement in general purpose financial institution areas.

FHLMC's 1983 legislative requests all fall within the first category and represent residential real estate operating authorities necessitated merely by a changing housing market. We are requesting authority to purchase manufactured housing loans classified under State law as personal property, conventional home loans insured by State housing finance agencies and secured subordinate home loans, commonly referred to as equity loans. We have provided as attachment A a more detailed description of our legislative requests.

In addition, we are requesting that the statutory mortgage purchase limits be increased for both FHLMC and FNMA to insure that families buying average priced homes in high cost areas have equal access to the supply of available housing credit at the lowest possible cost as do homebuyers in other areas. Senator Riegle mentioned California. It might interest you to know in 1978 the difference between our corporation's loan limit and the average price of a new home in California was roughly $8,500. Our information indicates that in 1983 that difference had increased to $60,000.

FHLMC's request for increased purchase limits is nothing more than a request from our seller/servicers (thrifts, commercial banks, and mortgage bankers), real estate brokers, and homebuilders who feel that there is a two-tiered market. This two-tiered market means that moderate income families who find themselves in high cost areas because of job opportunities are denied access to national secondary mortgage market prices.

Mr. Chairman, the General Electric Credit Corp. [GECC], and the Residential Funding Corp. [RFC], have expressed concern that even a modest increase in the FHLMC and FNMA loan limits will impede their growth. We say unequivocably it is not the intention of FHLMC to limit the growth of private sector secondary market corporations nor is it within our ability to do so. We need their help. The demands that are going to be placed in this sector on the secondary market will be beyond the capacity of the three national secondary market entities, and we encourage the Congress to look for reductions in the regulatory costs for these private entities to encourage greater involvement in the market.

Mr. Chairman, we are requesting a reasonable increase in our current mortgage limits in order to serve the housing market in higher cost areas. Together with the private sector, we can provide greater and needed support to the current housing recovery for families not currently served.

As you know, FHLMC is not now requesting any changes to its current structure. However, we believe that the FNMA proposals to provide a more responsive Board of Directors and more flexible oversight appear to be appropriate requests. Our Advisory Committee and Board of Directors have asked us to review this area in order to find ways to increase participation by our seller/servicer base and our stockholders. We will submit our findings for your review when they are completed.

The fundamental public policy issue confronting this committee and ultimately the Congress goes beyond the specifics of individual provisions to the FHLMC and FNMA Charter Acts. Essentially this committee must decide how far agency status should extend into markets beyond those for which we were specifically created to serve.

CHOICES IN RESOLVING PUBLIC POLICY ISSUES

In our view, the Congress has four readily identifiable choices in resolving this public policy issue:

First, Congress can decide that the Federal Government sponsorship of a national secondary market is no longer necessary.

Second, Congress can take the risk that sound private sector initiatives may be thwarted and provide FNMA and FHLMC with greatly broadened powers.

Third, in the short run, Congress can craft solutions on an issue by issue basis which will maximize support to housing by both public and private entities and at the same time insure the viability of the specialized secondary market entities.

Fourth, finally, Congress can search for a long-term solution to reconcile how a Government-sponsored corporation can pursue activities outside the narrowly defined secondary market in loans but without the advantage of the agency borrowing status in the capital market.

In listening to Mr. Kudlow earlier, I would find it very difficult to think that we could accomplish that in 2 weeks. We have spent considerable time prior to my coming with the Corporation trying to determine how one changes the orientation of a corporation that has, at least in the view of the market, the moral obligation of the U.S. Government. This is a very difficult matter. It is fraught with a number of very complex issues, but nevertheless it is worth an effort. I only question whether it can be done in 2 weeks.

My recommendation to you is that some combination of options three and four be used. Act now on those requests that are consistent with the legislative history defining appropriate agency activities in the secondary market. Those I put into category one.

We think that a solution can be found to the longer term issues, and we would be pleased to work with you as you address these issues as quickly as possible. In the meantime, we urge you to move forward on those proposals which enhance the ability of FHLMC and FNMA to fulfill their specialized function of assisting the continued development of a national secondary mortgage market and improve the structural form in which we do business. All four of our requests, including a reasonable increase in the FHLMC and FNMA loan limits, will insure that the benefits of the Government-sponsored national secondary mortgage market are provided nationally to middle-income home buyers without impeding the development of a private secondary mortgage market for housing loans.

I thank you for your attention.

[The complete statement follows:]

STATEMENT
OF

KENNETH J. THYGERSON
PRESIDENT
FEDERAL HOME LOAN MORTGAGE CORPORATION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I APPRECIATE THIS OPPORTUNITY TO TESTIFY ON FREDDIE MAC'S 1983 LEGISLATIVE PROPOSALS AND OTHER ISSUES RELATING TO THE ROLE OF THE FEDERALLY SPONSORED SECONDARY MORTGAGE MARKET CORPORATIONS. I COMPLIMENT THE COMMITTEE FOR ITS CAREFUL REVIEW OF OUR LEGISLATIVE REQUESTS IN THE CONTEXT OF OUR LONG TERM MISSION.

THIS HEARING IS ESSENTIALLY A CONTINUATION OF CONGRESSIONAL INTEREST IN THE NATION'S HOUSING FINANCE DELIVERY SYSTEM -- A SYSTEM WHICH IS UNDERGOING MAJOR CHANGE. I HAVE PREVIOUSLY DISCUSSED OUR ROLE IN THIS SIGNIFICANT TRANSITION WITH THE COMMITTEE, AND WOULD NOW LIKE TO HIGHLIGHT SEVERAL CONCLUSIONS WITH WHICH I BELIEVE WE CAN ALL AGREE. FIRST, MAJOR STATUTORY REVISIONS IN THE THRIFT INDUSTRY'S POWERS HAVE ALTERED THEIR NEAR MANDATORY ROLE IN HOUSING FINANCE AND, THEREFORE, DRAMATICALLY AFFECTED PREVIOUS PUBLIC POLICY. SECOND, BY EVEN CONSERVATIVE PROJECTIONS, HOUSING DEMAND FOR THE NEXT DECADE WILL BE SUBSTANTIAL. AND THIRD, THE SECONDARY MORTGAGE MARKET IS BECOMING ONE OF THE MOST IMPORTANT MEANS OF PROVIDING MORTGAGE CREDIT FOR HOMEBUYERS. THESE THREE CONCLUSIONS ALL SUGGEST THAT THE ROLE OF GOVERNMENT-SPONSORED SECONDARY MARKET ENTITIES WILL CONTINUE TO BE CRITICAL, AT LEAST IN THIS DECADE, IN ENSURING AN AVAILABLE AND AFFORDABLE SUPPLY OF MORTGAGE CREDIT AND IN PROVIDING THE MOST EFFICIENT FINANCIAL DELIVERY SYSTEM FOR THE NATION'S HOMEBUYERS.

LAST MONTH, I TESTIFIED BEFORE THE COMMITTEE AND HIGHLIGHTED WHAT FREDDIE MAC THOUGHT TO BE THE ISSUES FACED BY CONGRESS IN REVIEWING THE PUBLIC POLICY ROLE OF THE TWO NATIONAL SECONDARY MARKET CORPORATIONS.

THE ISSUES FACED BY CONGRESS GENERALLY FALL WITHIN THREE CATEGORIES: (1) THE EXTENT TO WHICH CONGRESS SHOULD PROVIDE BROADER POWERS TO ITS SECONDARY MARKET AGENCIES WHICH GO BEYOND THEIR SPECIALIZED FUNCTION OF ASSISTING THE DEVELOPMENT OF AND MAINTAINING A NATIONAL SECONDARY MORTGAGE MARKET, (2) THE LEVEL OF GOVERNMENT REGULATION AND SUPERVISION OVER OUR ACTIVITIES, INCLUDING THE EXTENT TO WHICH OUR FAVORABLE CREDIT POSITION IN THE CAPITAL MARKETS SHOULD BE APPLIED, AND (3) THE ISSUE OF HOW WE DO BUSINESS AND IN WHAT STRUCTURAL FORM.

WITH RESPECT TO BROADER OPERATING POWERS, WE BELIEVE THAT IT IS ENTIRELY APPROPRIATE FOR THE MANAGEMENTS OF STOCKHOLDER-OWNED GOVERNMENT CORPORATIONS TO REQUEST A WIDE RANGE OF OPERATING AUTHORITY BOTH TO FULFILL THEIR PUBLIC POLICY PURPOSES AND TO RESPOND TO THEIR FIDUCIARY RESPONSIBILITIES TO STOCKHOLDERS. HOWEVER, ANY REQUEST FOR BROADER POWERS MUST BE EVALUATED BY THIS COMMITTEE IN RELATION TO THE PUBLIC POLICY OBJECTIVES OF THE SECONDARY MARKET CORPORATIONS AS REPRESENTED BY OVER FORTY YEARS OF LEGISLATIVE HISTORY.

THIS LEGISLATIVE RECORD SUGGESTS THAT THE USE OF AGENCY STATUS AND THE SPECIAL ADVANTAGES THAT GO WITH IT SHOULD BE RESERVED FOR THOSE ACTIVITIES THAT ARE NOT, OR FOR SOME REASON CANNOT BE, ADEQUATELY PERFORMED BY THE PRIVATE SECTOR. FANNIE MAE, GINNIE MAE, AND FINALLY FREDDIE MAC WERE ALL CREATED ESSENTIALLY TO PROVIDE AND MAINTAIN A NATIONAL SECONDARY MARKET CAPABILITY FOR FHA, VA, AND CONVENTIONAL RESIDENTIAL MORTGAGE LOANS. ALL THE ACTIVITIES OF THESE AGENCIES HAVE BEEN CONFINED TO THE OBJECTIVE OF IMPROVING THE EFFICIENCY OF THE SECONDARY MORTGAGE MARKET AND INCREASING THE SOURCES OF CAPITAL FOR HOUSING.

WE FEEL THAT THE PUBLIC PURPOSE TO BE SERVED BY THESE ACTIVITIES ARE JUST AS IMPORTANT TODAY AS THEY WERE FORTY YEARS AGO. INDEED, THE DEMOGRAPHICS OF HOUSING DEMAND AND THE CURRENT CHANGES IN THE NATION'S SAVINGS AND LOAN BUSINESS SUGGEST THAT THE NEED FOR THESE SECONDARY MARKET ENTITIES WILL BE SUBSTANTIAL IN THE YEARS AHEAD.

THE ISSUE WE HOPE THIS COMMITTEE WILL CONSIDER IS WHETHER THE SPECIAL ADVANTAGES GRANTED TO THESE GOVERNMENT CORPORATIONS SHOULD BE EXTENDED INTO MARKETS THAT DO NOT RELATE TO PROVIDING A SECONDARY MARKET FOR RESIDENTIAL LONG-TERM LENDING.

HOW DO WE RECONCILE THE APPROPRIATE CONCERN OF STOCKHOLDER-OWNED GOVERNMENT CORPORATIONS TO FULFILL THEIR FIDUCIARY RESPONSIBILITIES TO THEIR OWNERS AND AT THE SAME TIME PUT MEANINGFUL LIMITS ON THE USE OF THEIR AGENCY "RUBBER STAMP" FINANCING ADVANTAGE? SHOULD GOVERNMENT SPONSORED CORPORATIONS BE ABLE TO USE THEIR SPECIAL BORROWING ADVANTAGE BEYOND THEIR SPECIALIZED FUNCTION TO COMPETE AGAINST PRIVATE COMPANIES IN THE SAME BUSINESS THAT FACE HIGHER BORROWING COSTS, NOT BECAUSE OF BAD MANAGEMENT OR WEAK FINANCIAL POSITIONS, BUT MERELY BECAUSE THOSE COMPANIES DO NOT HAVE AN "AGENCY" BORROWING STATUS?

IN CONSIDERING THE REQUESTS FOR BROADER POWERS WHICH ARE BEFORE THIS COMMITTEE, CONGRESS FACES FUNDAMENTAL ISSUES OF PUBLIC POLICY. WE HAVE BEEN ASKED TO COMMENT ON THESE PUBLIC POLICY ISSUES AND HAVE CAST OUR RESPONSE FROM THAT PERSPECTIVE.

WE BELIEVE, ANY DISCUSSION OF NEW OR EXPANDED POWERS FOR FEDERALLY CHARTERED SECONDARY MARKET CORPORATIONS CAN BE CATEGORIZED IN ONE OF THREE WAYS:

1. THOSE ENHANCING THE ABILITY OF GOVERNMENT-SPONSORED CORPORATIONS TO FULFILL THEIR CURRENT SPECIALIZED FUNCTION OF ASSISTING THE CONTINUED DEVELOPMENT OF A NATIONAL SECONDARY MORTGAGE MARKET.

2. THOSE POWERS WHICH WOULD EXPAND THE CURRENT SPECIALIZED FUNCTION TO ALLOW INVOLVEMENT IN REAL ESTATE RELATED AREAS, FOR EXAMPLE THE AUTHORITY TO PURCHASE RESIDENTIALLY RELATED COMMERCIAL LOANS.

3. THOSE POWERS WHICH WOULD EXPAND THE SPECIALIZED FUNCTION OF THESE ENTITIES TO ALLOW INVOLVEMENT IN GENERAL FINANCIAL INSTITUTION AREAS, FOR EXAMPLE POWERS GRANTED TO FEDERALLY CHARTERED SAVINGS AND LOAN INSTITUTIONS WHICH GO BEYOND RESIDENTIAL REAL ESTATE.

FREDDIE MAC'S 1983 LEGISLATIVE REQUESTS ALL FALL WITHIN THE FIRST CATEGORY AND REPRESENT RESIDENTIAL REAL ESTATE OPERATING AUTHORITIES NECESSITATED BY A CHANGING HOUSING MARKET. WE ARE REQUESTING AUTHORITY TO PURCHASE MANUFACTURED HOUSING LOANS CLASSIFIED UNDER STATE LAW AS PERSONAL PROPERTY, CONVENTIONAL HOME LOANS INSURED BY STATE HOUSING FINANCE AGENCIES AND SECURED SUBORDINATE HOME LOANS, COMMONLY REFERRED TO AS EQUITY LOANS. WE HAVE ATTACHED AS ATTACHMENT A A MORE DETAILED DESCRIPTION OF OUR LEGISLATIVE REQUESTS.

IN ADDITION, WE ARE REQUESTING THAT THE STATUTORY MORTGAGE PURCHASE LIMITS BE INCREASED FOR BOTH FREDDIE MAC AND FANNIE MAE TO ENSURE THAT FAMILIES BUYING AVERAGE PRICED HOMES IN HIGH COST AREAS

HAVE EQUAL ACCESS TO THE SUPPLY OF AVAILABLE HOUSING CREDIT AT THE LOWEST POSSIBLE COST AS DO HOMEBUYERS IN OTHER AREAS. THE CURRENT LIMIT OF $108,300 FOR SINGLE-FAMILY HOMES HAS NOT KEPT PACE WITH HOME PRICES IN A GROWING NUMBER OF HIGH COST AREAS.

EQUAL ACCESS TO THE NATIONWIDE SECONDARY MARKET IS CURRENTLY NOT AVAILABLE TO HOMEBUYERS IN THOSE PARTS OF THE COUNTRY WITH HIGHER COSTS OF LIVING. FOR EXAMPLE, A HOME COMPARABLE TO ONE COSTING $58,000 IN AKRON, OHIO, COSTS $110,000 IN HOUSTON, TEXAS, $115,000 IN SEATTLE, WASHINGTON, $128,500 IN MIAMI, FLORIDA, $166,000 IN SUBURBAN NEW YORK CITY, AND $235,000 IN SAN FRANCISCO, CALIFORNIA. THE CORPORATION IS REQUESTING A REASONABLE INCREASE IN ITS MORTGAGE LIMITS IN ORDER TO SERVE HOMEBUYERS PURCHASING AN AVERAGE PRICED HOME IN HIGH COST AREAS. AN INCREASE IN THIS CEILING WILL ALLOW THE CORPORATION TO BETTER SERVE ALL HOUSING MARKETS, NOTWITHSTANDING THE WIDE DIFFERENTIALS RELATING TO AVERAGE HOME PURCHASE PRICES AND WITHOUT DILUTING OUR SUPPORT OF THE HOUSING MARKETS WE ARE CURRENTLY SERVING.

MR. CHAIRMAN, GENERAL ELECTRIC CREDIT CORPORATION (GECC) AND THE RESIDENTIAL FUNDING CORPORATION (RFC) HAVE EXPRESSED CONCERN THAT EVEN A MODEST INCREASE IN THE FREDDIE MAC AND FANNIE MAE LOAN LIMITS WILL IMPEDE THEIR GROWTH. IT IS NOT THE INTENTION OR PUBLIC POLICY MISSION OF FREDDIE MAC TO LIMIT THE GROWTH OF PRIVATE SECTOR

SECONDARY MARKET CORPORATIONS NOR IS IT WITHIN OUR ABILITY TO DO SO. THE DEMAND FOR HOME FINANCING IS ENORMOUS AND WILL CONTINUE TO GROW. WE HAVE ESTIMATED THAT IN 1982, NEW MORTGAGE ORIGINATIONS NOT AVAILABLE FOR PURCHASE BY FREDDIE MAC AND FANNIE MAE TOTALLED APPROXIMATELY $25 BILLION. IN 1983, WE ESTIMATE THIS FIGURE WILL INCREASE TO $42 BILLION WORTH OF MORTGAGES ORIGINATED ABOVE THE $108,300 LIMIT. EVEN IF THE MORTGAGE LIMIT FOR BOTH CORPORATIONS WERE INCREASED TO $125,000 THIS WOULD STILL LEAVE $31 BILLION IN MORTGAGE LOANS ABOVE THIS AMOUNT EXCLUSIVELY FOR PURCHASE BY THE PRIVATE SECONDARY MARKET ENTITIES, IN ADDITION TO THOSE LOANS BELOW $125,000 NOT PURCHASED BY FREDDIE MAC AND FANNIE MAE. THE MOST OPTIMISTIC PROJECTIONS OF RFC AND GECC WILL BE A FRACTION OF THIS AMOUNT. WE, THEREFORE, REQUEST A REASONABLE INCREASE IN OUR CURRENT MORTGAGE LIMITS IN ORDER TO SERVE THE HOUSING MARKET IN HIGH COST AREAS. ALL OF THE PUBLIC AND PRIVATE ENTITIES TOGETHER CANNOT NOW SERVE CURRENT HOUSING CREDIT NEEDS. WITH A REASONABLE INCREASE AND TOGETHER WITH THE PRIVATE SECTOR, WE CAN PROVIDE GREATER AND NEEDED SUPPORT TO THE CURRENT HOUSING RECOVERY FOR FAMILIES NOT CURRENTLY SERVED.

MR. CHAIRMAN, THESE FOUR LEGISLATIVE PROPOSALS WILL ENHANCE OUR ABILITY TO FULFILL OUR SPECIALIZED CONGRESSIONAL MISSION OF ESTABLISHING A NATIONAL SECONDARY MORTGAGE MARKET. SIMILARLY, WE FEEL THAT PROPOSALS SUCH AS FANNIE MAE HAS OFFERED TO PROVIDE A MORE

RESPONSIVE BOARD OF DIRECTORS AND TO PROVIDE MORE FLEXIBLE EXECUTIVE BRANCH OVERSIGHT OVER THE DAY-TO-DAY PROGRAMMATIC OPERATIONS OF FNMA APPEAR TO BE APPROPRIATE REQUESTS DESIGNED TO MAXIMIZE THE EFFICIENCY AND RESPONSIVENESS OF THAT CORPORATION.

AS YOU KNOW, FREDDIE MAC IS NOT REQUESTING ANY CHANGES TO ITS CURRENT STRUCTURE. HOWEVER, FREDDIE MAC AND FANNIE MAE BOTH SHARE THE RESPONSIBILITY FOR ENSURING MAXIMUM PARTICIPATION BY THEIR STOCKHOLDERS. OUR STOCKHOLDERS, AS DO FANNIE MAE'S, REQUIRE THAT WE QUICKLY AND PROFITABLY RESPOND TO THE CHANGING NEEDS OF THE HOUSING INDUSTRY. FOR EXAMPLE, IN ORDER TO ASSIST FREDDIE MAC MANAGEMENT IN ITS DECISION MAKING, WE HAVE ASSEMBLED AN ADVISORY COMMITTEE MADE UP OF LEADING HOUSING EXPERTS FROM A WIDE SPECTRUM OF THE HOUSING INDUSTRY. THIS COMMITTEE, INCLUDING LEADERS FROM THE SAVINGS AND LOAN, HOME BUILDING, REALTOR®, MORTGAGE INSURANCE, MORTGAGE BANKING AND SECURITIES INDUSTRIES HAS PROVIDED IMPORTANT ASSISTANCE TO THE CORPORATION'S MANAGEMENT.

BOTH THE ADVISORY COMMITTEE AND OUR BOARD OF DIRECTORS HAVE ASKED US TO BEGIN TO EXPLORE WAYS TO FURTHER MAXIMIZE THE INPUT OF OUR STOCKHOLDERS AND SELLER/SERVICER BASE. ALTHOUGH WE HAVE ONLY NOW BEGUN TO REVIEW THIS ISSUE, WE HOPE TO BRING OUR RECOMMENDATIONS BEFORE THIS BODY AT THE APPROPRIATE TIME REGARDING THE COMPOSITION OF OUR BOARD OF DIRECTORS AND METHODS WHEREBY OUR STOCKHOLDERS CAN

MORE FULLY PARTICIPATE AND BENEFIT IN THE ACTIVITIES OF THE CORPORATION.

OTHER PROPOSALS NOW BEFORE THIS COMMITTEE APPEAR TO US TO GO BEYOND THE HISTORIC SPECIALIZED CONGRESSIONALLY DICTATED SECONDARY MARKET FUNCTION ASSIGNED TO FREDDIE MAC AND FANNIE MAE. FOR EXAMPLE, WE CURRENTLY CARRY OUT OUR MISSION BY ISSUING MORTGAGE PASS-THROUGH SECURITIES GUARANTEED BY THE CORPORATION. OUR CURRENT CHARTER ACT ENABLES US TO GUARANTEE MORTGAGE PASS-THROUGH SECURITIES ISSUED BY ELIGIBLE SELLERS, REPRESENTING INTERESTS IN LOANS WE ARE AUTHORIZED TO PURCHASE. ALTHOUGH WE HAVE NOT USED THIS AUTHORITY, IT WOULD BE ENTIRELY CONSISTENT WITH OUR CHARTER TO GUARANTEE FOR THE INVESTOR, THE BORROWER'S PAYMENT OF MORTGAGE PRINCIPAL AND INTEREST AS WE DO NOW FOR SOME $45 BILLION OF FREDDIE MAC SECURITIES. WE ARE CURRENTLY EXAMINING WHETHER THIS PROVIDES A MORE EFFICIENT MEANS TO CARRY OUT OUR MISSION. FANNIE MAE HAS ASKED FOR EQUIVALENT AUTHORITY, AND WE BELIEVE IT SHOULD BE QUICKLY APPROVED.

HOWEVER, AUTHORITY TO GUARANTEE THE MORTGAGE-BACKED DEBT ISSUANCES OF PRIVATE LENDERS IS ENTIRELY DIFFERENT. IN THIS CASE, OUR "AGENCY" STATUS IN THE CAPITAL MARKET WOULD BE USED TO GUARANTEE THE INSTITUTIONS' ABILITY TO REPAY THEIR DEBT ISSUANCES. THIS TYPE OF AUTHORITY COULD BE EMPLOYED TO ENHANCE THE CREDIT RATINGS OF COMPETING INSTITUTIONS. HERE, WE QUESTION WHETHER IT IS APPROPRIATE

TO ESSENTIALLY SELL AN "AGENCY STAMP OF APPROVAL". DOES SUCH AUTHORITY GO BEYOND THE SPECIALIZED FUNCTION FOR WHICH WE WERE CREATED, AND WOULD IT SIGNIFICANTLY AUGMENT THE SUPPLY OF AFFORDABLE HOUSING CREDIT? THESE ARE COMPLEX QUESTIONS ON WHICH REASONABLE PEOPLE DIFFER. AT THIS TIME, IT WOULD APPEAR THAT THE MARKET DOES NOT REQUIRE THIS TYPE OF ASSISTANCE.

THE COMMITTEE ALSO HAS BEEN ASKED TO DECIDE IF A FEDERALLY CHARTERED SECONDARY MORTGAGE MARKET CORPORATION SHOULD HAVE THE AUTHORITY TO PURCHASE RESIDENTIALLY RELATED COMMERCIAL LOANS. ALTHOUGH FREDDIE MAC HAS NOT REQUESTED THIS FUNCTION, WE HAVE BEEN ASKED WHETHER WE WOULD ALSO LIKE TO BE GRANTED SUCH AUTHORITY. THIS IS ANOTHER EXAMPLE OF A PROPOSAL THAT WE BELIEVE GOES BEYOND THE CURRENT SPECIALIZED SCOPE OF A GOVERNMENT-SPONSORED SECONDARY MARKET FACILITY. IN THE ABSENCE OF MARKET NEED, WE QUESTION WHETHER CONGRESS SHOULD EXTEND THE BENEFITS OF GOVERNMENT "AGENCY" STATUS IN THE CAPITAL MARKET TO A SEGMENT OF INDUSTRY SERVED ENTIRELY BY THE PRIVATE SECTOR. WE WANT TO MAKE IT CLEAR, HOWEVER, THAT IF THE COMMITTEE AND CONGRESS -- AFTER ADDRESSING THESE BASIC POLICY ISSUES -- DETERMINES THAT IT IS APPROPRIATE TO EXTEND BROADER POWERS TO FANNIE MAE, WE FEEL THAT IT WOULD BE APPROPRIATE IN MOST CASES TO PROVIDE SIMILAR AUTHORITY TO FREDDIE MAC.

THE FUNDAMENTAL POLICY ISSUE

THE FUNDAMENTAL PUBLIC POLICY ISSUE CONFRONTING THIS COMMITTEE AND ULTIMATELY THE CONGRESS GOES BEYOND THE SPECIFICS OF INDIVIDUAL PROVISIONS TO THE FHLMC AND FNMA CHARTER ACTS. ESSENTIALLY THIS COMMITTEE MUST DECIDE HOW FAR AGENCY STATUS SHOULD EXTEND INTO MARKETS BEYOND THOSE FOR WHICH WE WERE SPECIFICALLY CREATED TO SERVE. FNMA'S MANAGEMENT AND STOCKHOLDERS HAVE VERY PROPERLY ASKED FOR AN EXPANSION OF THEIR COMPANY'S OPERATIONAL AUTHORITY BEYOND ITS SPECIALIZED FUNCTION FOR THE PURPOSE OF MAXIMIZING PROFIT. WHILE THIS IS AN UNDERSTANDABLE AND EVEN LAUDABLE REQUEST, CONGRESS SHOULD CONSIDER THIS PROPOSED EXPANSION WITHIN A BROADER CONTEXT.

AS NOTED EARLIER, CONGRESS MUST SOMEHOW RESOLVE THE POTENTIALLY INCONSISTENT GOAL OF GOVERNMENT-SPONSORED CORPORATE STOCKHOLDERS WHO WANT TO MAXIMIZE PROFITS WITH THE REALITY OF A BALANCED PUBLIC POLICY THAT ENCOURAGES THE GROWTH OF THE PRIVATE SECTOR.

IN OUR VIEW, THE CONGRESS HAS FOUR READILY IDENTIFIABLE CHOICES IN RESOLVING THIS PUBLIC POLICY ISSUE:

1. CONGRESS CAN DECIDE THAT THE FEDERAL GOVERNMENT SPONSORSHIP OF A NATIONAL SECONDARY MARKET IS NO LONGER NECESSARY.

2. CONGRESS CAN TAKE THE RISK THAT SOUND PRIVATE SECTOR INITIATIVES MAY BE THWARTED AND PROVIDE FANNIE MAE AND FREDDIE MAC WITH BROADENED POWERS.

3. IN THE SHORT RUN, CONGRESS CAN CRAFT SOLUTIONS ON AN ISSUE BY ISSUE BASIS WHICH WILL MAXIMIZE SUPPORT TO HOUSING BY BOTH PUBLIC AND PRIVATE ENTITIES AND AT THE SAME TIME ENSURE THE VIABILITY OF THE SPECIALIZED SECONDARY MARKET ENTITIES.

4. CONGRESS CAN SEARCH FOR A LONG-TERM SOLUTION TO RECONCILE HOW A GOVERNMENT-SPONSORED CORPORATION CAN PURSUE ACTIVITIES OUTSIDE THE NARROWLY DEFINED "SECONDARY MARKET" IN LOANS BUT WITHOUT THE ADVANTAGE OF THE "AGENCY" BORROWING STATUS IN THE CAPITAL MARKET.

THESE FOUR CHOICES ARE DIFFICULT ONES TO HAVE TO CONSIDER. HOWEVER, IT SEEMS TO ME THAT SEVERAL OF THESE OPTIONS ARE VERY RISKY AND SHOULD BE REJECTED AT THIS TIME. OPTION ONE SHOULD BE REJECTED BECAUSE OF THE NEED FOR STRONG SECONDARY MARKET FACILITIES TO PROVIDE SERVICE ON A NATIONWIDE BASIS TO MEET THE TREMENDOUS NEED FOR HOUSING CREDIT IN THIS DECADE. WE SHOULD, HOWEVER, CONSTANTLY

REVIEW THE PROGRESS BEING MADE BY THE PRIVATE SECTOR SO THAT THE AGENCIES DO NOT STAND IN THE WAY OF FULL PRIVATE PARTICIPATION IN THE SECONDARY MARKET.

SIMILARLY, I BELIEVE THAT OPTION TWO SHOULD BE REJECTED SINCE THE TOTAL LIBERALIZATION OF AGENCY ASSET POWERS HAS IMPLICATIONS FAR BEYOND THOSE RELATING TO PUBLIC POLICY CONCERNING HOUSING AND MORTGAGE FINANCE. A GOOD ANALOGY RELATES TO THE USE OF TAX-EXEMPT REVENUE BOND AUTHORITY. IF THE CONGRESS HAD NO SANCTIONS ON THE USE OF TAX-EXEMPT REVENUE BOND AUTHORITY, THERE WOULD BE STRONG ECONOMIC INCENTIVES FOR SOME STATE AND MUNICIPAL BONDING UNITS TO FINANCE MANY PRIVATE SECTOR ACTIVITIES WITH TAX-EXEMPT BONDS. THE CONGRESS CLEARLY HAS A RESPONSIBILITY HERE TO ENSURE THAT THE USE OF THE AGENCY "RUBBER STAMP" IS NOT PROVIDED INDISCRIMINATELY IN THE AREA OF FINANCING COMMERCE OR INDUSTRY WHERE THE PRIVATE SECTOR IS ALREADY SUCCESSFULLY ENGAGED.

OUR RECOMMENDATION TO YOU IS THAT SOME COMBINATION OF OPTIONS THREE AND FOUR BE USED TO FIND A WAY OF RECONCILING THE ISSUES OF APPROPRIATE PUBLIC POLICY AND GOVERNMENT-SPONSORED CORPORATION STOCKHOLDER EXPECTATION. WITH RESPECT TO OPTION FOUR, A COMMON METHOD IN THE PRIVATE CORPORATE WORLD FOR BRANCHING INTO NEW ACTIVITIES IS TO FORM DE NOVO OR PURCHASE A SUBSIDIARY WHICH IS

SUBJECT TO THE LAWS, CHARTER LIMITATIONS, AND REGULATIONS APPLYING TO THAT PARTICULAR ENTITY. THIS IS AN OPTION WHICH CONGRESS MAY WISH TO EXPLORE.

WE THINK THAT A SOLUTION CAN BE FOUND TO THESE ISSUES, AND WE WOULD BE PLEASED TO WORK WITH YOU AS YOU ADDRESS THESE CRUCIAL POLICY QUESTIONS. IN THE MEANTIME, WE URGE YOU TO MOVE FORWARD ON THOSE PROPOSALS WHICH ENHANCE THE ABILITY OF FREDDIE MAC AND FANNIE MAE TO FULFILL THEIR SPECIALIZED FUNCTION OF ASSISTING THE CONTINUED DEVELOPMENT OF A NATIONAL SECONDARY MORTGAGE MARKET AND IMPROVE THE STRUCTURAL FORM IN WHICH WE DO BUSINESS. ALL FOUR OF OUR REQUESTS, INCLUDING A REASONABLE INCREASE IN THE FREDDIE MAC AND FANNIE MAE LOAN LIMITS, WILL ENSURE THAT THE BENEFITS OF THE GOVERNMENT SPONSORED NATIONAL SECONDARY MORTGAGE MARKET ARE PROVIDED NATIONALLY TO MIDDLE INCOME HOMEBUYERS WITHOUT IMPEDING THE DEVELOPMENT OF A PRIVATE SECONDARY MORTGAGE MARKET FOR HOUSING LOANS.

ATTACHMENT A

FREDDIE MAC'S 1983 LEGISLATIVE REQUEST

FREDDIE MAC HAS REQUESTED THE OPERATIONAL AUTHORITY TO PURCHASE MANUFACTURED HOUSING LOANS CLASSIFIED UNDER STATE LAW AS PERSONAL PROPERTY. IT IS THE CORPORATION'S INTENT TO DEVELOP A GUARANTEED SECURITY INSTRUMENT IN ORDER TO SELL THESE LOANS TO THE INVESTMENT COMMUNITY, ONCE A PURCHASE PROGRAM PROVES SUCCESSFUL IN TERMS OF VOLUME, STANDARDIZATION, AND PRICE. WITH THE AUTHORITY TO PURCHASE THESE LOANS, FREDDIE MAC WILL BE ABLE TO BRING MOBILE HOME LOANS INTO THE CONTEMPORARY SYSTEM OF HOUSING FINANCE. WE ARE REQUESTING THIS NEW AUTHORITY BECAUSE IT IS ENTIRELY CONSISTENT WITH OUR CONGRESSIONAL CHARTER AND PURPOSE BY ENCOURAGING THE GROWTH OF AN AFFORDABLE ALTERNATIVE TO SITE BUILT HOUSING FOR LOW AND MODERATE INCOME FAMILIES, PARTICULARILY FIRST-TIME HOMEBUYERS.

WE ARE ALSO REQUESTING THAT CONGRESS PROVIDE A LIMITED INCREASE IN THE MAXIMUM LOAN AMOUNT ELIGIBLE TO BE PURCHASED BY BOTH FREDDIE MAC AND FANNIE MAE. AN INCREASE IN OUR LOAN LIMIT WILL ENABLE HOMEBUYERS PURCHASING AVERAGE PRICED HOMES LOCATED IN HIGH COST AREAS TO HAVE EQUAL ACCESS TO THE SUPPLY OF AFFORDABLE AND AVAILABLE MORTGAGE CREDIT.

THE CORPORATION IS REQUESTING THIS AUTHORITY BASED UPON EVIDENCE THAT THE HOUSING MARKET IS NOT BEING ADEQUATELY SERVED IN HIGH COST AREAS -- NOT TO IMPEDE THE GROWTH OF NEW PRIVATE SECTOR SECONDARY MARKET ENTITIES. THE CORPORATION'S STATED MISSION IS TO PROVIDE A SECONDARY MARKET FOR CONVENTIONAL MORTGAGE LOANS AND TO PROMOTE THE DEVELOPMENT OF THIS SECONDARY MARKET BY ENCOURAGING THE GROWTH OF PRIVATE ENTITIES ENTERING THIS MARKET. HOWEVER, IT IS IMPORTANT FOR THE COMMITTEE TO RECOGNIZE THAT NEITHER FREDDIE MAC, FANNIE MAE, NOR EXISTING PRIVATE CONDUITS ARE CURRENTLY SERVING THE HOUSING CREDIT NEEDS OF FAMILIES PURCHASING AVERAGE PRICED HOMES IN HIGH COST AREAS ON A NATIONAL BASIS. CONGRESS SOUGHT TO PROVIDE AN ADEQUATE SUPPLY OF MORTGAGE CREDIT AT REASONABLE PRICES TO HOMEBUYERS THROUGH THE CREATION OF THE FEDERALLY CHARTERED SECONDARY MARKET CORPORATIONS. HOWEVER, THE HOUSING MARKET HAS DEVELOPED UNEVENLY ACROSS THE COUNTRY, PARTICULARLY IN CITIES AND SMSAS CREATING WIDE DIFFERENTIALS IN HOME PRICES. THIS HAS RESULTED IN DISCRIMINATORY ACCESS TO AVAILABLE AND AFFORDABLE CREDIT FOR MANY HOMEBUYERS.

FAMILIES PURCHASING AN AVERAGE PRICED HOME IN A HIGH COST AREA ARE OFTEN REQUIRED TO PAY A PREMIUM FOR MORTGAGE CREDIT BECAUSE THEIR LOAN, WHICH IS ABOVE THE CURRENT MORTGAGE LIMIT, IS NOT SALEABLE IN THE SECONDARY MARKET.

For example, based on data provided by National Relocation Service, a home valued at $77,500 in Pittsburgh, Pennsylvania, would cost:

$121,500	in	Washington, DC
$139,500	in	Walnut Creek, CA
$135,000	in	Stamford, CT
$103,500	in	Shreveport, LA
$103,500	in	Seattle, WA
$202,500	in	San Rafael, CA
$121,000	in	San Jose, CA
$211,500	in	San Francisco, CA
$115,000	in	St Paul, MN
$108,000	in	Portland, OR
$149,500	in	New York City, NY suburban
$148,500	in	New York City, CT suburban
$175,000	in	Oakland, CA
$139,500	in	Minneapolis, MN
$211,500	in	Menlo Park, CA
$107,000	in	Fort Lauderdale, FL
$103,500	in	Billing, MT
$115,000	in	Miami, FL
$103,500	in	Providence, RI

BASED ON THE CORPORATION'S ANALYSIS, IN 1983 $24 BILLION OF MORTGAGE LOANS ORIGINATED WILL NOT BE ELIGIBLE FOR PURCHASE BY FREDDIE MAC AND FANNIE MAE UNDER THEIR CURRENT LIMITS. EVEN THE MOST EXPLOSIVE GROWTH OF THE PRIVATE SECONDARY MARKET ENTITIES WILL NOT BE ABLE TO FILL THIS ENORMOUS DEMAND. THE FOLLOWING REPRESENTS OUR BEST ESTIMATE OF ORIGINATION VOLUMES NOT AVAILABLE FOR PURCHASE BY FREDDIE MAC AND FANNIE MAE IN 1982-1984.*

	Total Originations	Volume of Loans With Amounts Less Than $108,300	Volume of Loans with Amounts Between $108,300 & $125,000	Volume of Loans With Loan Amounts Greater Than $125,000
1982	$ 95 billion	$ 70 billion	$ 7 billion	$18 billion
1983	$160 billion	$118 billion	$11 billion	$31 billion
1984	$230 billion	$169 billion	$16 billion	$45 billion

* The major assumptions behind these figures relate to the method of generating a loan amount distribution in the projection for total residential originations and the average loan-to-value ratio.

- o The average loan amount distribution was estimated from recent new and existing home sales data. This is a reasonable approximation if refinancing and homes that do not require financing have sales prices distributed similarly to actual new and existing home sales. One might argue that higher priced homes are less likely to be financed and that as a result the estimates of the market above our loan limits are overstated. This could well be due to limited secondary market access in the past, and the argument could be moot.

- o Total originations in 1982 were approximately $95 billion. Total originations in 1983 and 1984 were assumed to be $160 billion and $230 billion based on Regional Data Associates' most recent projection.

- o The average loan-to-value ratio was assumed to be 80 percent. If loan-to-value ratios are higher for higher priced homes, our figures will understate the share of the market over our loan limits.

IF THE CORPORATION WERE ALLOWED TO PURCHASE LOANS UP TO $125,000 THIS WOULD MEAN THAT APPROXIMATELY $76 BILLION IN NEW MORTGAGE ORIGINATIONS OVER $125,000 WOULD BE AVAILABLE EXCLUSIVELY FOR PURCHASE BY THE PRIVATE SECTOR IN 1983 AND 1984 COMBINED. OUR PROJECTIONS ARE REASONABLE, GIVEN THE ASSUMPTIONS WE HAVE EMPLOYED. THE FACT REMAINS THAT NEITHER THE FEDERALLY CHARTERED CORPORATIONS NOR THE PRIVATE SECTOR SECONDARY MORTGAGE MARKET CORPORATIONS CAN EVEN COME CLOSE TO SERVING THE PROJECTED DEMAND FOR MORTGAGE CREDIT OVER THE NEXT FEW YEARS. FOR THE BENEFIT OF THOSE FAMILIES PURCHASING AVERAGE PRICED HOMES IN HIGH COST AREAS, WE URGE A LIMITED INCREASE IN BOTH FREDDIE MAC'S AND FANNIE MAE'S LOAN LIMITS.

WE ARE ALSO REQUESTING CHARTER ACT AUTHORITY TO EXPAND OUR CURRENT AUTHORITY TO PURCHASE LOANS SECURED BY JUNIOR LIENS. ALTHOUGH THE CORPORATION NOW HAS A PURCHASE PROGRAM FOR SECURED ENERGY AND HOME IMPROVEMENT LOANS SUBORDINATE TO FIRST MORTGAGE LIENS, THE PROGRAM HAS NOT BEEN USEFUL IN ASSISTING HOMEOWNERS WHO NEED TO SECURE SECONDARY FINANCING TO ENTER HOMEOWNERSHIP OR WHO WISH TO USE THEIR HOME EQUITY FOR OTHER THAN ENERGY CONSERVATION OR HOME IMPROVEMENT PURPOSES. BETWEEN 1979 AND 1981, THE VOLUME OF JUNIOR LIEN LOANS CLIMBED FROM $9.5 BILLION TO $19 BILLION. THESE FIGURES DO NOT ACCOUNT FOR THE GENERALLY SHORT-TERM JUNIOR LIENS RESULTING FROM SELLER HELD CREATIVE FINANCING, WHICH IS ESTIMATED TO

TOTAL BETWEEN $10 AND $15 BILLION IN 1980 AND 1981. WITH THIS AUTHORITY, THE CORPORATION WILL BE ABLE TO EXPAND HOME MORTGAGE FINANCING OPTIONS FOR HOMEBUYERS AND PROVIDE NEEDED LIQUIDITY TO LENDERS BY REPLENSHING THEIR SUPPLY OF FUNDS FOR NEW ORIGINATIONS.

FINALLY, WE ARE REQUESTING CHARTER ACT AUTHORITY TO PURCHASE MORTGAGE LOANS INSURED BY STATE HOUSING FINANCE AGENCIES AS WE WOULD ANY OTHER CONVENTIONAL MORTGAGES. CURRENTLY, THE CORPORATION CANNOT BUY MORTGAGE LOANS THAT HAVE THE BENEFIT OF STATE HOUSING FINANCE AGENCY INSURANCE UNDER ITS CONVENTIONAL MORTGAGE PURCHASE PROGRAMS. THIS RESTRICTION WAS IMPOSED PRIOR TO THE DEVELOPMENT OF STATE HOUSING AGENCY INSURANCE PROGRAMS FOR HOME LOANS AND IS IMPEDING OUR ABILITY TO RESPOND TO A CHANGING MARKETPLACE. ALTHOUGH ONLY THREE STATES AND PUERTO RICO HAVE ACTIVE STATE AGENCY MORTGAGE INSURANCE PROGRAMS, THE CORPORATION BELIEVES IT SHOULD BE ABLE TO PROVIDE A SECONDARY MARKET OUTLET FOR THIS DEVELOPING PART OF THE HOUSING MARKET.

Senator Tower. Thank you, Mr. Thygerson.

Mr. Tucillo.

STATEMENT OF JOHN TUCILLO, DIRECTOR, CENTER FOR HOUSING AND COMMUNITY DEVELOPMENT RESEARCH, THE URBAN INSTITUTE, WASHINGTON, D.C.

Mr. Tucillo. Thank you, Mr. Chairman. With your permission, I will enter my statement in the record and summarize it.

Senator Tower. Your statement and those of your colleagues here and your supporting documents will be included in full in the record.

[The complete statement follows:]

Expanding the Secondary Mortgage Market

Testimony of
John A. Tuccillo
Director, Center for Housing and Community Development Research
The Urban Institute

Mr. Chairman and members of the Committee:

I am happy to be here and wish to thank you for the invitation to appear before you to discuss the proposed amendments that would broaden the powers of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). My name is John Tuccillo and I am Director of the Center for Housing and Community Development Research at the Urban Institute, a non-profit research institution here in Washington. I am a specialist in housing finance markets and have written extensively on both primary and secondary mortgage markets. In addition, I have testified before the House Banking Committee on the proposed recapitalization of FHLMC.

In general, I would support the proposed amendments, since they will create the facility to cover a gap that currently exists in the secondary mortgage market. However, one cannot assess the proposed changes without looking at the current state and probable future of the secondary mortgage market. At the moment, there is an embryonic private presence in the market that will eventually become a major factor. Changes that will permit FNMA and FHLMC, with their federal patina, to choke off the development of private market participants would be dangerous. Rather, an expansion of powers must be judged by its contribution to a secondary mortgage market that contains both the current federally-related agencies (whether quasi-public or fully private) and newer, private institutions. I would conclude that the proposed amendments will not choke off the private market, but that they ought to be used as part of a process that will form the secondary market of the future. The remainder of my testimony will amplify these thoughts by discussing the future of the secondary mortgage market, the impact of the proposed amendments and the process by which the amendments may contribute to shaping the market.

The Future of the Secondary Mortgage Market

The mortgage finance system as we have known it for the past half century is gone. The mainstay of that system, the thrift institution, has been so profoundly shaken by economic adversity and government regulation that it will never again exhibit the same type of behavior that made it such a significant mortgage investor. Rather, the thrift institution of the future will originate mortgages, but will be as likely to sell them and retain servicing function as to hold them in portfolio. The trend has already begun: savings and loan associations accounted for nearly a quarter of all mortgage loan sales in 1980; in 1970, the figure was less than 6 percent. Moreover, the utilization of the new powers being implemented through the deregulation legislation of 1980 and 1982 will cause many thrift institutions to originate fewer mortgages. In sum, the role of the traditional suppliers of mortgage funds will be greatly diminished in the future.

But Americans will still buy houses and they will still demand financing for those purchases. The funds to finance mortgages will have to come from somewhere, and that somewhere is the secondary market. In the future, the secondary market will have two major roles. The first of these is to accommodate the need for liquidity of savings and loans associations, mortgage banking firms and other institutions that are traditional actors in the primary mortgage market. This is the function that has been developed in the seventies by the secondary market. In the future it will need to be expanded and made sufficiently flexible to accommodate the diverse needs of the new institutional operating methods and new institutional investors. This implies the development of new programs to accommodate both the new types of lending instruments and different investors needs. In the former regard, FNMA has been quite active. The new purchase programs aimed at older, low-rate mortgages, and new renegotiable mortgages, as well as the programs packaging these instruments for sale to ultimate investors, represent a response to the need of the primary market for increased liquidity and flexibility.

Second, the secondary market must be able to serve as a conduit for the introduction of other institutional investors, like pension funds and life insurance companies, into the mortgage market. This implies the development of financing vehicles that will appeal to the demands of these institutions for return, liquidity and marketability, as well as the particular investment goals of individual firms. An example of this type of development is the attempt by FNMA to reach pension funds through its new mortgage-backed security. Essentially, it is accepting for guarantee pools from a single orginator arguing that pension funds that seek investments in a particular geographic area will be attracted to these securities.

To reach this future, however, the secondary market must overcome a number of obstacles that currently affect the market. Apart from the general long-term uncertainty that bothers the markets for all fixed income securities, the secondary mortgage market also suffers from the lack of a sufficient mechanism to insure investor protection against the call of the security. At present, investors assume that the yield to the mortgaged-backed security is variable downward (as mortgagees prepay in the face of falling interest rates) but not upward. This reduces the attractiveness of mortgage-backed securities and hampers the role of the secondary market agency in accessing new funds to the mortgage market. The lack of call protection is compounded by typically severe mortgage interest rate volatility and the thinness of the market in certain types of mortgages. Both of these will adversely affect the investor's expected yield and thus restrict the market for mortgage-backed securities, unless a sufficient hedging opportunity for these securities is provided.

A second type of problem is the restriction of mortgages and mortgage-backed securities as an allowable investment for many types of fiduciary investors, like pension funds. Without the legal right to hold mortgages, pension funds cannot be looked upon as a probable source of mortgage funds in the future. Recent Department of Labor changes in ERISA regulations have ameliorated part of this problem, but these regulations do not resolve it completely as they restrict investment to those mortgages that meet FHLMC, FNMA, or GNMA standards. This restricts the secondary mortgage market access for pension funds to federally-sponsored entities.

Third, the problems of scale that afflict the secondary mortgage market need to be overcome. Currently, issuing fees effectively preclude a mortgage security issue of less than $25 million. While this proves no problem to the federally-related agencies (due both to lower issue costs and the ability to package large issues), it prevents many private issues from taking place. This problem has been partially resolved by the emergence of "conduits", mortgage jobbers who combine small sellers into a large issue. However, there are few conduits in operation and these few operate at a substantial disadvantage relative to the federally-related agencies.

Finally, the menu offered by secondary market agencies must be expanded if they are to fulfill their role in housing finance in the future. To tie the mortgage market completely into other capital markets—the necessary step in attracting funds to housing from what are not now traditional housing investors--secondary market agencies need to provide the flexibility and diversity offered to investors by these markets. The basic elements are already there, in the sense that mortgages are now being packaged in a reduced-risk, homogeneous form (mortgage-backed securities). But the mortgages being packaged represent only a small segment of the total mortgage market, and all are backed by the guarantee of a federal or federal-sponsored organization. At present, the stock of conventional mortgages sold through securities issued as the responsibility of a purely private entity are about 0.3 percent of the stock of all mortgages. Even when one adds the mortgages backing the FHLMC Participation Certificates into this total, conventional mortgage-backed securities make up less than 3 percent of the mortgage market. The secondary market clearly needs to offer an attractive package that will allow investment in conventional mortgage by private investors across the broad range of the maturity spectrum sought by different investors. To do this, however, will require institutional change, a point we discuss below.

On the other side of the market, the secondary market agencies must develop instruments that will allow mortgage originators the flexibility of retaining or selling the mortgages they close. In the future, lenders will be less willing to assume all the interest rate risk associated with mortgage investment and will attempt to use adjustable rate mortgages (ARMS) to a greater degree. The ability of the originator to sell ARMS on the secondary market will figure significantly in the lender's decision to close a loan. FNMA and FHLMC have begun to develop instruments that will allow the originator this option by offering to purchase ARMS under different forms. The proposed amendments would add purchase authority for second liens, mobile home loans and other types of housing loans. These programs may never prove to be significant, but they are necessary in the changing housing finance system. The sorting out of programs and instruments is crucial to the development of one part of the secondary market, and can best be done in a climate where private actors are co-equal with federally-related entities as market participants.

The need for expansion and improvements of the secondary market for mortgages implies that all the agencies now serving that market will have a significant role in the future. However, the scarcity of financial resources and the nature of the risks inherent in the secondary market for mortgages suggest that the role of each of the current agencies--FHLMC, FNMA, GNMA--will be different. At present, the secondary mortgage market consists of one federal and two federally-sponsored agency. Two of the three, FHLMC and GNMA, provide for the pooling of mortgage loans and their issue as securities backed by the federal government. In the case of GNMA, the federal guarantee is backed up by the presence of federal insurance on the mortgages that make up the pool. In the case of FHLMC, the securities that convey ownership of the pooled mortgages are themselves the obligations of a federal agency. FNMA has begun a mortgaged-backed securities program, but its federal advantage is indirect, in the form of easier and cheaper access to capital markets, where it raises the funds used to acquire mortgages for its portfolio. For the most part, purely private activity in the secondary mortgage market is confined to direct placement of mortgages, with some minor issue of mortgaged-backed securities. Thus, the secondary market is currently a federal creation and operation.

Here lies the importance of both FHLMC and FNMA in the secondary mortgage market of the future. FHLMC is by experience positioned to be a conduit for conventional mortgages; FNMA is a somewhat more diversified role. They can, as a quasi-private or fully private institutions, facilitate the development of private securities issued on the basis of pools of conventional mortgages. This is a function that the secondary market has heretofore lacked and a function that GNMA will never fill. FNMA and FHLMC have the expertise, the experience and the scale to serve as the market makers for the private financial institution that wishes to sell its mortgages to other investors.

Let me expand on this bit. In its current structure, FHLMC has developed mortgage and security forms and underwriting standards that have allowed it to deal successfully with both thrift institutions and with mortgage investors. Its scale is large enough for it to have established a market reputation and credibility with investors. The current drawback is the limitation imposed by its capital structure. The achievement of private status by FHLMC would remove that capital limitation and create a secondary market entity with a strong market presence. The presence could serve not only to allow the making of a market in conventional mortgage-backed securities, but also as an example to other potential market entrants who might wish to serve a similar function.

FNMA, on the other hand, is positioned to play a slightly different role in the secondary mortgage market. Compared to FHLMC, FNMA is a more diversified financial institution. In the secondary market of the future it will serve as the provider of liquidity and portfolio diversification for mortgage lenders and for mortgagees that do not currently participate in the secondary market. Thus, while retaining its identification with the mortgage market, FNMA would in fact enter the general financial services market in a significant way.

The key to these developments is the attainment of private status. There are essentially two reasons for this. First, the expansion of the secondary mortgage market requires a qualitative change as well as a quantitative change. For FNMA, the partial movement to private status may have been no movement at all. The market clearly views FNMA securities as federal securities and thus grants FNMA a large market concession. Such would be the case with a partially-private FLHMC. Any expansion of capital would be regarded as an increase in federal credit and an increase in PCs or similar securities would add nothing to the market's experience with private conventional mortgage-backed and thus nothing to its willingness to accept other issuers.

Private entities will be able to establish a broader range of securities to suit the needs and demand of new issuers and investors. For both FNMA and FHLMC to fill efficiently their roles in the secondary market of the future, they must move to full private status as quickly as possible.

Second, full development of the secondary market requires a freedom from potentially counterproductive federal control. As we saw during the Carter Administration, relations between FNMA and HUD need not always be smooth. When a conflict emerges, it is entirely possible that the resolution may point FNMA down an inefficient path. Investors recognize the potential here and will treat FNMA obligations accordingly. Similarly, the limitations on FHLMC's capital will provide to be a significant barrier to the development of the Corporation's activities.

The Proposed Amendments

FNMA and FHLMC have proposed amendments to their operating powers that would both increase the scope of their existing programs and (particularly in the case of FNMA) change the nature of those programs. Specifically, both ask that the loan limits placed on their purchases be raised from the current ceiling of $108,300. In addition, FHLMC is seeking authority to purchase manufactured housing loans, junior liens and state agency insured issues. FNMA is asking permission to purchase mortgages on nonresidential mortgages for properties that serve the needs of residential areas. There are two sets of issues involved in the assessment of these requests. The first of these is the impact on competition between the federally-related agencies and the private secondary market, both as it currently exists and as it may exist in the future. The second set of issues deals with the impact of the changes on the character of the agencies.

Competitive Issues. At present, the secondary mortgage market consists of three federally-related entities--FNMA, FHLMC and GNMA--that control the vast majority of the market, and a small, relatively new and growing private sector, characterized by the activities of firms such as the Residential Finance Corporation. In general, the private firms are dealing in mortgage paper that is insured by private mortgage insurers, that is sufficiently homogeneous to allow pooling for security issue purposes, and in large denominations (RFC, for example, will purchase mortgage with nominal values up to $500,000). Given these conditions, the private market is a direct competitor with the federal agencies in all areas except for mortgage size. Increasing the FHLMC and FNMA loan limits, then, may bring the agencies into closer competition with private firms. Since the agencies carry the federal imprimatur and thus have lower borrowing costs, this increased competition carries the danger that the growth of the private sector will be permanently stunted.

The validity of this argument cannot be judged without reference to figures on private market activity. Unless we know which mortgage are being traded by private firms, we cannot ascertain the degree to which the competition exists. Three points, however, suggest that despite the potential damage to the private market increasing the loan limits for the federally-related agencies is warranted. First, economies of operational scale indicate that, in its early stages, the private secondary mortgage market will concentrate on larger mortgages, which are less costly to process and may be underwritten more conveniently. This is a section of the market that FNMA and FHLMC are unable and unwilling to satisfy.

Second, the degree to which FNMA and FHLMC will encroach on the private market is limited under the proposed amendments. The FHLMC request would increase its loan purchase limit to $125,000, which would still leave private firms ample scope for growth. In the case of FNMA, there would be no loan limit, but the allowable purchases would be restricted to 20 percent of the dollar amount of the previous year's loan purchases. Currently, that limit would work out to no more than about 11 percent of all loans on properties valued at $145,000 or more, even if FNMA doubled its share of mortgages purchased. In both cases, there does not seem to be sufficient potential for FNMA or FHLMC to actually squeeze private firms out of the secondary mortgage market.

Finally, there is the impact on the scope of agency operations of fixed loan limits in a world of increasing house prices. The limit of $108,300 will preclude both FNMA and FHLMC from providing liquidity services to originators of about 25 percent of all residential mortgage loans by 1984. This suggests a gap in the market that private firms are not yet ready to fill.

For all these reasons, increasd loan purchase limits for both FNMA and FHLMC appear justified.

The Nature of FNMA and FHLMC. Besides the amendments to increase loan purchase limits, both agencies have proposed new types of purchase authority. Granting of this authority will alter the nature of both agencies in subtle but significant ways. For FHLMC, the authority to purchase mobile home loans, second trusts and state agency mortgages would set its character as an agency that will service all segments of the residential finance market. If an analogy is appropriate here, FHLMC is becoming a kind of mortgage boutique, whose wares are varied and attractive, yet are restricted to one area of merchandising. By expanding its powers to move into nonresidential mortgages, FNMA is bidding to become a department store, which carries a wide variety of merchandise.

In neither case, will this alteration in character prove to be a threat to the private secondary mortgage market firm. FHLMC will cover areas that, for the most part, will appear unattractive to the private firm. Risk considerations suggest that it will be a long time before purely private firms will be willing to initiate purchase programs to cover mobile home loans or second mortgages. Similarly, if FNMA is to compete in the private sector, it will be with Merrill Lynch or the Sears Financial Network; in other words, with the large financial department stores. The market identity will be that FNMA is grounded in the mortgage market, while Merrill Lynch has its origins in securities trading and Sears in retail sales.

I believe that the expansion of purchase programs requested by the two agencies is beneficial both to the mortgage market in general and the firms themselves. The new programs will fill gaps in the secondary market, and they will set the agencies on a course that will establish their ultimate character.

Next Steps

As my previous comments have suggested, I have in mind a long run configuration for the secondary mortgage market. In brief, I see a market in which private firms dominate, in which FNMA and FHLMC are themselves private, and in which gaps in the market (lower income mortgages for example) are covered by GNMA. To say that the market is private, however, is not to deny the presence of market power. Indeed, it is entirely possible that the secondary mortgage market may be characterized by few and large firms which offered differentiated products. A market in which FNMA deals in residential and commercial mortgage purchasing, in which FHLMC serves the residential market in all its variety, in which purely private firms purchase and pool large mortgages for specific investor groups and in which GNMA serves the low-income, FHA-insured market is conceivable and may well be inevitable.

The problem has always been how to get there. For the past few years, FNMA's lack of profitability has been a barrier to its transition to full private status. Recently, the need to link the two agencies as part of any movement to private status has caused considerable anguish. No feasible plan has yet been brought forward that would render FNMA and FHLMC private within a reasonable time frame or in a way that would not severely hurt either entity.

I believe that these amendments provide a partial solution to these problems. While these hearings are not focussed on the transition of FNMA and FHLMC to the private sector, there is an opportunity here that should not be discarded. The movement to nonresidential mortgage purchases by FNMA, limited as it is, and the addition to FHLMC's powers of loan purchase authority for "difficult" loans, sets the two agencies off in different directions and a decoupling of their movement to private status. Now, should FNMA become private before FHLMC, the residual federal advantage will not introduce a competitive disadvantage, because the two firms will be conducting different operation within the secondary market. While the granting on some small additional powers may seem a slender thread on which to hang such a major policy change, I think it is a beginning that can be pushed until it results in an orderly and productive return of each of the agencies to the private sector, each in its own time.

The immediate operational step here is to tie the granting of nonresidential mortgage purchase authority, and other increases in powers for FNMA to the relinquishment of the federal tie, in terms of both the concessions in debt cost it allows and the supervision by HUD that it imposes. I believe that the passage of these amendments can and should be tied to the setting of a definite schedule for the weaning of FNMA from the federal government. This process ought to take place as a joint consultation between FNMA and HUD, under the supervision of the relevant Congressional committees.

The question of FHLMC can, and should, be treated separately. This agency will eventually become completely private, but is not yet as ready as is FNMA to do so. The development of programs such as the proposed mobile home, junior lien and state agency mortgage purchases will do much to establish for FHLMC a distinct market character that it needs in order to make an effective transition to the private sector. When this is established, I would put FHLMC through a process similar to that I am proposing for FNMA.

Senator **Tower**. Thank you, Mr. Tucillo.

We will suspend the hearing for about 8 to 10 minutes to go vote and return for questions.

[Recess.]

Senator **Tower**. Senator Riegle is recognized.

Senator **Riegle**. Thank you, Mr. Chairman.

I was wondering if any of you would like to comment on the testimony and discussion in the earlier part of the hearing. I would welcome comments from all three of you.

Mr. **Maxwell**. Thank you, Senator.

I think there are three things that I would comment upon, although there are many more. But you have many more witnesses.

No. 1, Mr. Kudlow talked about the housing recovery and how good it was and how satisfied he is with that. But I think it is important to remember that the housing recovery starts had the worst year—1982—that housing has encountered since the Second World War. And I am not sure they have records before that.

While the recovery in percentage terms may look very strong, it is not carrying housing back to the heights that it had reached in some years in the past, and I am not at all sure that it is satisfying the demand of American home buyers, and particularly first-time home buyers, for housing in this country.

WITHOUT FNMA A TOTAL CATASTROPHE IN HOUSING

The second matter has to do with Mr. Kudlow's statement that he doesn't really think Fannie Mae did any good for housing in 1982. That leaves me speechless, since I think without Fannie Mae what was a terrible year would have been a total catastrophe for housing, and I believe any group in housing, even perhaps those that are opposing some parts of our legislation, would have to agree with that.

Senator **Riegle**. Could you explain that a little more?

Mr. **Maxwell**. Well, the reason I say that is because Fannie Mae bought $15 billion of loans, and that was one out of every six home loans made.

Now, if that financing had not been available, the thrifts would not have had the funds to make those loans, because other sources were not available.

Freddie Mac became extremely active in the last quarter of the year, but prior to that time had not been active in buying newly originated mortgages during the year. Simply, the financing provided by Fannie Mae supported the market through much of the year.

One thing we particularly did was to furnish a market for builders to move their inventory. We instituted a process of negotiated transactions, and we sat across the table from builders and lenders from all over the country who had specific types of mortgages and types of products they wanted to use to get the inventory and to enable buyers to buy their homes.

The result of that was about $7.7 billion of such negotiated transactions, done both here in Washington and in our regional offices. And without them, I am told wherever I go, that many builders simply could not have survived that period.

Senator RIEGLE. So is it fair to say, then, in your judgment perhaps last year was one of the most poor years in terms of the performance that you feel you are able to make and the support you are able to give the housing market, or what was left of it at that time of severe difficulty?

Mr. MAXWELL. Yes, sir. That is my position, and furthermore, our position in this hearing in seeking this legislation is that this is exactly what Fannie Mae is for. Our market share goes down—share of the secondary market goes down in years like the current one, where interest rates are more stable and there is plentiful mortgage money, and in years where that is not the case Fannie Mae steps in, as does Freddie Mac.

Senator RIEGLE. Does anybody else want to make any specific comment?

Mr. THYGERSON. I just want to reiterate one point. I thought that the Kudlow testimony did raise many of the conceptual issues that were very similar to the ones I raised.

In having dealt with this subject on a practical and theoretical basis, I will reiterate that I think it is virtually impossible to do anything within a 1- or 2-week period much more than raise the conceptual issues. So maybe you can divide up these proposals so they can be put in various conceptual boxes.

Some boxes we should delay on now and more fully consider, but in other boxes we may be able to move forward on more quickly.

I don't think that within 2 weeks, given many of the legal market ramifications of these issues that you can resolve the long-term public policy and structural issues in that period of time.

Mr. TUCILLO. I agree with Mr. Thygerson on that.

Senator RIEGLE. I yield the balance of my questions at this point.

Senator TOWER. Senator Proxmire.

Senator PROXMIRE. Mr. Maxwell, Fannie Mae has considerable powers, as listed by Mr. Kudlow. You have a U.S. Treasury line of credit of $2.25 billion; you are eligible for open market purchases lateral from Federal Reserve Bank advances and discounts at a lower interest rate.

EXEMPT FROM SEC REGISTRATION

You are exempt from SEC registration and related accounting disclosure requirements, from which I am sure every firm would be delighted to be exempt.

Your securities account is legal investments for federally supervised institutions, again giving you a market that other institutions do not have. Your securities are eligible to collateralize public deposits, including Treasury, tax, and loan accounts, and you are able to use the Federal Bank as a fiscal agent.

So these seem to me to be very, very substantial public powers that do differentiate you from a private operation.

And the reason I ask that is I would like to know in the first place what is your basic salary?

SALARY STRUCTURE

Mr. MAXWELL. Senator, my salary is $310,000.

Senator PROXMIRE. And in 1981 the salary was $196,000?

Mr. **Maxwell**. In 1981, the salary was $225,000.

Senator **Proxmire**. Oh, that was before 1981.

Mr. **Maxwell**. I would like to point out, Senator, since the subject has been raised, that salary is not paid by the taxpayers. It is paid by the stockholders out of the operation of Fannie Mae.

Senator **Proxmire**. Well, operations, though, that are obviously assisted in the way that are indicated here. You don't run the kind of risk—thanks to the Government, thanks to all these various advantages you have—that a private firm would run.

Mr. **Maxwell**. Yes, sir, we do run those risks because, while there is ultimate Government backing for Fannie Mae, as there is for other financial institutions and, indeed, for Chrysler Corp. and others in this economy, the fact of the matter is that Fannie Mae could go bankrupt, and very nearly did, which would wipe out the investments of the stockholders.

Senator **Proxmire**. Well, except the implication is, and the feeling among investors is, that the Federal Government stands behind it.

After all, with a line of credit of $2.25 billion from Uncle Sam, I think it would seem unlikely that the Federal Government could stand by and let you go belly up.

Mr. **Maxwell**. There was an article by Jane Bryant Quinn in Newsweek recently, which is an excellent article, which pointed out the meaning of that moral obligation. It does not mean, Senator, respectfully, that people do not look at our credit.

In fact, in 1981 almost all of the funds except Merrill Lynch that invest in Government securities or Government-related securities stopped buying Fannie Mae. People do look at our credit.

We are subject to market discipline. We do, under our congressional charter, have to raise our money in the private market in order to support our operation.

[The following magazine article was submitted for the record:]

[From Newsweek magazine, Mar. 7, 1983]

"Moral Obligations": How Secure?

(By Jane Bryant Quinn)

So suspicious have investors grown about safety that not even issues linked to the U.S. government are being taken on trust. Some securities, like Treasury bills, notes and bonds, are backed by the "full faith and credit" of the United States. That's a *true* guarantee. If necessary, the government will print the money needed to pay interest and principal on time. But other issues—backed by government agencies or given a right to borrow from the U.S. Treasury—are considered only "moral obligations" of the federal government. That's one step removed from a government guarantee.

To the credit markets, it's a baby step. No one seriously questions the government's commitment to its moral-obligation issues. As proof of faith, such issues typically sell for only a half-point or so more than comparable Treasuries. But if you invest in a money-market mutual fund that specializes in government securities, some moral-obligation notes smell like a skunk at a tea party. So what, if the Congress won't let them fail? It might take Congress a while to decide that, and in the meantime, interest payments might be delayed.

FANNIE MAE

A case in point is the money funds' reaction to the Federal National Mortgage Association—the famous Fannie Mae—a corporation that's federally chartered but privately run. Fannie Mae raises money in the public markets to invest in residential mortgages. Its job is to keep money flowing into the housing markets, to which end it has been officially designated an "instrumentality" of the federal government. No one truly believes that the Congress would let Fannie Mae default on its notes or debentures. But that's a practical, or moral, obligation. There's no direct government guarantee.

Fannie Mae lost $190.4 million in 1981, and several money-market mutual funds took it off their list of securities approved for purchase. Lower interest rates and better management cut its losses last year to $104.9 million, but the cautious funds haven't yet relented. "In the recent past, if a major crisis happened, we estimated that Fannie Mae could have gone through its line of credit at the U.S Treasury in a couple of weeks," says Edward Taber, president of T. Rowe Price's Prime Reserve Fund and U.S. Treasury Money Fund. "Bureaucratic, legislative and administrative delays would come about in structuring a rescue package," he adds, "and we're not in the business of buying obligations that might have delays in payment." If Fannie Mae goes into the black for a couple of quarters, Taber might put it back on the approved list.

Several other government-linked securities also lack direct federal guarantees (chart), but are not hip deep in financial problems like Fannie Mae. For the Prime Reserve Fund, Taber keeps the major farm lenders on his approved list—the Banks for Cooperatives, the Federal Land Bank and the Federal Intermediate Credit Banks. He's also happy with the Federal Home Loan Bank, which lends to savings and loan associations. The Student Loan Marketing Association (Sallie Mae) buys government-guaranteed student loans, but it's new in the market and Taber has no official opinion on it yet. Other moral-obligation securities are not normally followed by money-fund analysts, because their maturities are too long for the funds' short-term portfolios.

Conservative savers stick with money funds that buy only full-faith-and-credit issues, principally Treasuries. But not all Treasury funds are alike. Instead of owning all their securities outright, many funds made loans to government-securities dealers and secure the loans with Treasury bills. These arrangements, called repurchase agreements or repos, almost came to grief after the bankruptcy of a government-securities dealer called Lombard-Wall. The following question came before a federal court in New York: can a money fund immediately recoup the loans it made to a bankrupt dealer by selling the Treasuries it holds as collateral? Or does it have to wait until the bankruptcy proceedings are finished? The court okayed an immediate sale, but another court might answer differently—and if it did the fund's investors would lose money. Most money funds continue to use repos while trying to shore up their legal position in the event of future bankrupticies. A few funds, however, avoid even this tiny risk by not using repos.

CHOICES

For people investing directly in government-linked securities rather than buying money funds, George Hester, a vice president of Paine Webber, suggests the Federal Farm Credit Banks. For a minimum of $5,000 you can buy six- or nine-month bonds that normally yield about a quarter-point more than comparable Treasuries (although recently they've been paying about the same). On maturities of 13 months or more, the minimum investment of $1,000. The FFCB secures its issues with grain, farm fields, livestock and other agricultural assets. In the seven-to-ten-year area, Hester suggests the securities of the Federal Home Loan Bank. They pay a quarter to half a point more than Treasuries on a minimum investment of $10,000, and are secured by mortgages and government securities. Like most Treasuries, FHLB issues are usually not callable if interest rates fall.

You pay no state or local income taxes on the interest earned from Treasury, FFCB or FHLB issues. By contrast, Fannie Mae (minimum individual purchase: $10,000) is taxed at the state and local level.

The small investor, however, should consider whether it's worth switching from Treasuries to government-agency securities just for an extra quarter or half a point. If you had to sell before maturity you might not get as good a price on agencies, which could all but eliminate your yield advantage. Agency securities are far more interesting when they're paying two points or more above Treasuries, which can happen at a time when the agencies are doing a lot of financing. That's something your broker can watch for you.

GINNIE MAES

Among the most popular government securities are the pools of insured mortgages guaranteed by the Government National Mortgage Association, or Ginnie

Mae. Every month, investors get a check representing their share of the principal and interest being paid on the underlying mortgages. You also get a pro rata share of any mortgages that have been prepaid in full. If you spend each monthly check, you are using up your principal as well as interest, which is just what a retired person might want to do. But a younger saver should be banking or reinvesting the proceeds.

The 30-year mortgages pooled in a Ginnie Mae are expected to be fully prepaid over 12 years. That would give them a current yield of 12.3 percent, compared with 10.6 percent on Treasury notes. But in practice, these pools are being prepaid over roughly 11 to 14 years, according to Norman Schvey, director of Merrill Lynch's bond-fund division. Changes in prepayment rates will affect the yield you get on your investment and the size of the check you receive each month. So you never know exactly what your Ginnie Mae will ultimately yield.

When interest rates fall, lower-interest mortgages may be paid off a little more slowly than average, and higher-interest mortgages may be paid off a little faster. In either case, the yield would be lower than if your Ginnie Mae had lasted the expected 12 years. To offset this risk, higher-interest Ginnie Maes are now being priced to deliver slightly better yields.

YIELDS

Professional investors say there's an interesting play in older Ginnie Maes that carry interest rates of 6 to 7 percent. These mortgage pools will be prepaid in *less* than 12 years and therefore are carrying relatively higher yields.

It costs a minimum of $25,000 to buy into a new Ginnie Mae or $1,000 for a Ginnie Mae mutual fund or unit trust. Newer unit trusts may offer a mix of high- and low-rate mortgages. "Under current market conditions, I can get a higher yield by being half in 16 percent mortgages and half in 8 percent mortgages than I can by putting all my money in 12 percent mortgages," Schvey says.

Unlike other agency securities, Ginnie Maes are taxable at the state and local levels. But they carry a 100 percent, full-faith-and-credit government guarantee.

THE SAFETY NET

All government-linked securities are considered safe but only the agencies in the top list offer a direct guarantee.

Guaranteed

Chrysler Corp. Loan Guarantee Board;
Export-Import Bank;
Farmers Home Administration;
Federal Housing Administration;
Government National Mortgage Assn.;
Maritime Administration;
Penn Central Transportation;
Small Business Administration;
Student Loan Marketing Assn.; [1]
U.S. Treasury.

Moral obligation

Federal Farm Credit Consolidated Securities;
Federal Home Loan Banks;
Federal Home Loan Morgage Corp;
Federal National Mortgage Assn.;
Student Loan Marketing Assn.;[1]
Tennessee Valley Authority;
U.S. Postal Service.

Senator **Proxmire**. Now, Mr. Maxwell, as I understand it, you have other income in addition to salary from Fannie Mae; is that correct?

Mr. **Maxwell**. Well, I think that other income is——

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[1] Guaranteed if issued prior to July 1, 1982.

Source: First Boston Corp.

Senator PROXMIRE. From your 1982 performance share plan award, the information I have here is you received $193,000 and that your total income from Fannie Mae was $503,000.

Mr. MAXWELL. That is not correct.

Senator PROXMIRE. Not correct?

Mr. MAXWELL. No, sir.

Senator PROXMIRE. In what respect is it not?

Mr. MAXWELL. The performance share plan was instituted by the Board of Directors of Fannie Mae, with the approval of the shareholders, to provide an incentive for the officers—all of the officers of Fannie Mae—to reach certain financial objectives. That is a very common thing in business.

The first plan to which you refer is a 4-year plan. There are no awards that have been made under that plan, nor will there be any if we have not achieved the objectives as to cumulative profit by the end of the 4-year period, which is at the end of 1985.

I have not received any awards in that plan. I am not guaranteed any award in that plan, nor is any other officer of Fannie Mae, and I would like to say this is the fifth largest corporation in terms of assets in the country.

Our salary schedule, which we have had worked on by independent experts, including Towers, Perrin, Foster & Crosby, a very highly respected firm in the field, has determined that, generally speaking, our salary levels, and specifically mine, Senator, are substantially below comparable financial institutions.

Senator PROXMIRE. You deny what I have here is an excerpt from the Fannie Mae of 1983 proxy statement that shows "David Maxwell, Chairman of the Board, CEO, $310,000 salary, $193,000 from other. These amounts include 1982 and performance share plan awards, exact amounts which are unavailable"?

Mr. MAXWELL. Well, I don't deny that is on a piece of paper, and I don't deny that is in the proxy statement, Senator, but I do deny that that is a cash payment. That is an accrual which is required by generally accepted accounting principles in the event that we succeed in meeting objectives at the end of the period.

Senator PROXMIRE. That is very helpful clarification.

Then the $193,000 was not paid you in cash; however, it is accrued and if you meet certain standards, that $193,000 will accrue to you?

Mr. MAXWELL. Unfortunately, I am not an accountant, so I can't tell you why they chose that specific sum of money, but the fact of the matter is that this plan is not only based on the achievement of the objectives, but it also is an award which will be measured by the average price of the stock in the final months of the fourth year, which is December of 1985, so that the stockholders have to benefit as well as the officers in order for there to be any payment.

If the stock is selling for $2 a share, then the award will be practically nil, even if we do achieve the objectives.

Senator PROXMIRE. The information I have is that you have received $310,000, which you have confirmed, in salary.

Mr. MAXWELL. That's my current salary.

Senator PROXMIRE. It is 50 percent higher than the President of the United States receives. It's higher than any other Government official receives, and while you argue you have a private operation here and that compared to other private corporations it's modest and perhaps low, it seems to me that this is so vested with the public interest and with public assistance and public support that it's fair to compare it with these other areas.

We are talking about privatization.

Mr. **Maxwell**. I really don't see our ultimate support from the Government as any different from Citibank or Chase Manhattan or any other financial institution in this country which ultimately will be backed up by the Government.

Senator **Proxmire**. Well, you have a Treasury line of credit of $2.25 billion; Citibank has no——

Mr. **Maxwell**. They have deposit insurance.

Senator **Proxmire**. No money credit.

Mr. **Maxwell**. They have $100,000 Government insurance, which is the backing of the Government. That's a very important issue.

Senator **Proxmire**. Well, they have deposit insurance based on a premium they pay and all other banks pay to get deposit insurance.

None of that comes from the taxpayer. There's never been a bank failure that has resulted in any loss to the Federal Government.

We have had a number of them, but they have been paid out of the pool that's been put together by premiums paid in by the banks; am I correct?

Mr. **Maxwell**. Yes. I think to a large extent the premiums have covered by what has been the paid-out. We of course, have paid taxes and made payments in lieu of taxes prior to that time.

We don't receive any Federal appropriation of any kind, Senator, and I do not think that you would want to entrust $74 billion of assets, which might in fact if not handled properly result in a cost to the taxpayers, to people who cannot command comparable salaries.

We could not get people that we need to run this large entity correctly without appropriate salary schedules.

Senator **Proxmire**. That may be a good reason for privatization. I agree you get what you pay for in this world, and particularly in financial operations.

On the other hand, look at the Federal Reserve Board; they have enormous powers, great responsibility, critical as far as our economy is concerned and they are paid a fraction of what you receive.

You look at other regulatory agencies that also have very great responsibility and they are paid relatively little.

I'm not arguing against high salaries. I'm all for them. I think if I were a director of a corporation, I'd want to get the best and the only way you get the best is by paying for it.

But I'm saying you're in a different position as long as you're a quasi-public operation and as long as you have these very substantial powers.

Let me ask you this: On April 22, Senator Tower wrote to you expressing his concern that as we continue to proceed along the deregulation path for Fannie Mae, that we have a corresponding reduction in the financial backing the Federal Goverment provides your agency.

PHASING OUT GOVERNMENT FINANCIAL BACKING

I share his concerns and I support his request that you provide this committee with a long-term plan for phasing out the Federal Government's financial backing.

However, on page 13 of your statement, you seem to reject Senator Tower's request and urge instead immediate action on your legislative proposals.

If you are not willing to provide the committee with your thinking on a Federal phaseout plan at this time, why should we act promptly on your legislative proposals?

Mr. **Maxwell**. Well, Senator, I certainly did not reject Senator Tower's suggestion. The fact of the matter is, that I think there is a very major distinction to be made between the changes that Fannie Mae is requesting to strengthen its ability to survive in today's legislation and the long-term restructuring of the secondary market.

As I also said in my statement, we are devoting a great many resources to that very question and we welcome the opportunity of participating with the committee in considering that question and in fact——

Senator **Proxmire**. Well, I'm glad to hear that. In other words, you would have no objection to sitting down over a group with Mr. Kudlow and discussing this?

Mr. **Maxwell**. I have no objection. I have to tell you, Senator, that I have been discussing this matter with Mr. Kudlow for 2 years.

Senator **Proxmire**. He wanted to broaden it, as I understand it, and have people from the Congress and so forth take part.

Mr. **Maxwell**. I think if it's broadened, that certainly the whole question of Federal agencies like Farm Credit and the Federal Home Loan Banks and Freddie Mac and Sallie Mae and Fannie Mae might well be considered together. But I do not think the committee should delay the enactment of the modest proposals we have made while that process goes forward.

Senator **Proxmire**. You say, on page 13, "Any change in Fannie Mae's traditional role—any change as a federally sponsored privately owned enterprise in the secondary mortage market can only come once our self-help efforts have resulted in long-term improvements in Fannie Mae's balances."

That sounds like years rather than weeks.

Mr. **Maxwell**. Well, Senator, let me try to sort of expand on that: 94 percent of our assets are 30-year fixed rate mortgages.

Our strategy is to try to reduce that by selling loans out of our portfolio and acquiring shorter-term assets while still supporting the long-term mortgage market.

But while we have a substantial amount of fixed-rate, long-term mortgages, and while there is this mismatch between our assets and our liabilities, the question of the privatization of Fannie Mae is a very long-term question.

We believe that we have made enormous progress in putting this company on the right road, and if in fact we had not made the changes that we have made, then the situation would be truly hopeless for ever considering a private Fannie Mae.

There is an alternative which I would not be so presumptuous as to suggest, but we could become private overnight if the Government would do something with the $40 billion of mortgage loans that yield less than 10 percent that are on our books and are going to stay there.

Most of them are FHA and VA loans, they are assumable and they aren't going away, and this makes for a permanent weakness in our financial structure which needs to be corrected and which we are dedicated to correcting. I have already started on that process.

Senator **Proxmire**. I apologize to the chairman and the other witnesses, because I know that the hour is very late. But I do have two questions that will take, I hope, a minute or two and perhaps you can give us a brief answer. I have one very brief question for Mr. Maxwell and one for Mr. Thygerson.

Mr. Maxwell, the question is this: It was reported in yesterday's New York Times—I have the article here—that FNMA has exerted undue pressure on private companies to obtain support for legislation that will greatly expand FNMA's lending authority.

Would you comment on that article and on the point made that since FNMA is partly in the public sector and, I quote, "Some of the things that were happening," were not appropriate?

Mr. **Maxwell**. Well, Senator, I am glad you brought that up, because it was an extremely distressing article. I want to say that it is not the policy of FNMA to make business decisions based on the legislative positions of any person or company, but I think that I need a few minutes to answer that question.

Last year there was a piece of legislation pending in the House. It was considered at hearings, which FNMA opposed vigorously, because we felt it would seriously damage the Corporation. We made our views know to firms in Wall Street with whom we have extensive dealings and asked if they could support us. Three of those firms—Salomon Bros., First Boston Corp. and Lehman Bros.—appeared at the hearing and took positions diametrically opposed to that of FNMA and just flatout opposed us. We have done millions and millions of dollars of business with those firms. There has been absolutely no change in our attitude toward those firms, as a result of their position. And there would be no change toward mortgage insurance companies based on any position that they might take on any legislative matter.

The fact of the matter is that the first I knew of any such activity was that New York Times report. I have begun to look into it. I do not know of any particular substance to it. If there was any instance of that, I feel certain that it may have come from someone who was under pressure. We have been under enormous stress in the last 2 years and someone may have just gotten a little annoyed and said, "Look, why aren't you guys supporting our legislative program?"

But I can tell you, Senator, that I will stake my personal integrity and that of our company on the fact that we do not engage in that sort of matter, and it is not our policy and not our practice and it never will be.

Senator **Proxmire**. Well, I appreciate that reassurance. It's very helpful to have that.

TAKEOVER POSSIBILITY

And the only other questions that I have to ask Mr. Thygerson. Mr. Thygerson, if you should be privatized, there is a possibility, I understand that there might be an effort to take over FHLMC.

Mr. **Thygerson**. I would hope that investors would find the corporation desirable.

Senator **Proxmire**. I understand you would be a desirable target. Suppose some firm in an unrelated area took over FHLMC. What effect do you think that might have on your function as a national resource for housing?

Mr. **Thygerson**. Well, Senator, that clearly depends on what vestige of our Government relationship continues to exist. Right now in the financial institution field, there seems to be a tremendous interest on the part of nonbanking institutions to buy financial institutions that have insurance of accounts. There would appear to be an incentive to obtain the ability to use that insurance of accounts to attract money in the retail and wholesale markets. If we have a vestige of Government borrowing advantage left as a private institution, one might view that advantage as a very desirable incentive for some private institutions to buy us in order to obtain that advantage That would be one aspect of why we would be a desirable target. If we continued to have a vestige of Government status for our borrowing activities, we would be a very major target for acquisition by some very large institution which would want to use that ability to generate vast sums of money for a variety of purposes.

The other side of our value has to do with the business side of FHLMC, the value added, as Larry Kudlow used the term, in what we do. We have a distribution network, we have good contacts, and good business relationships with over 2,000 seller/services on a nationwide basis. That distribution system and our specialized knowledge in the security market are valuable pieces of knowledge to acquire. On that basis, even extracting our Government agency advantage, we would be a desirable target.

Senator **Proxmire**. Thank you, Mr. Chairman. I apologize for taking so much time.

Senator **Tower**. May I first say that in my view, Mr. Maxwell has brought FNMA back from the brink of disaster, which required consummate corporate skill, and I think that the salary is certainly not out of line, considering what is ordinarily paid in the business community. I think as far as that, he's worth every dime he's being paid.

I preside over a committee that has oversight over 3 million people, that spends $250 billion a year, for a salary of $60,600 a year. But I think that's totally irrelevant to what they pay the business community, and we are recognizing around here we are going to have to pay our staff members more than we are getting to retain good staff members. Many senior staff are now being paid more than the Senators, so I think these matters are unrelated. Many of us work for the Government out of public service more than not, and I think Mr. Maxwell's salary should not be at issue.

Mr. Thygerson, what would you think of permitting the corporation to acquire existing institutions as subsidiaries, which could be separated from the agency benefits of the parent corporation, and thus function on an equal footing with other non-Government competitors? You can both comment on it.

Mr. THYGERSON. I think it's a proposal which, frankly, we have not had a chance to look at in any detail. That requires a myriad of evaluation. However, when a diversified corporate institution or diversified industrial institution chooses to get in the financial business, it does so through acquisition. Typically, it will buy a savings and loan, a commercial bank, or some other financial institution and subject itself to the same regulatory requirements for those institutions that they would be competing against.

So on that competitively fair basis, I would say that the acquisition idea has merit. It is an idea that could be looked at when this TIM's proposal comes before this committee because it may have merit in that area as well.

So, a group is convened and brought together to consider the future activities of Government-sponsored corporations, I would recommend that this proposal be looked at.

Senator TOWER. Mr. Maxwell?

Mr. MAXWELL. Sir, I just would echo what Mr. Thygerson has said. We have been having discussions with members of the committee staff on this point, and we would like to continue those in the future, and we certainly don't rule it out. We believe there are certain problems about the proposal for FNMA, but we certainly want to look at the matter.

Senator TOWER. Gentlemen, I have some additional questions I'd like to submit for response in writing, for the record. If you could respond to those in timely fashion, I would be grateful to you.

Senator TOWER. We appreciate your appearing here today, and your testimony.

The committee will stand in recess until 2:30 this afternoon.

[Whereupon, at 12:45 p.m., the hearing was recessed, to reconvene at 2:30 p.m., this same day.]

[Responses to additional questions of Senator Tower follow:]

Federal National Mortgage Association

3900 Wisconsin Avenue, NW, Washington, DC 20016
202 537 6770

David O. Maxwell
the Board
[illegible]

August 16, 1983

Honorable John Tower
Chairman
Subcommittee on Housing and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

I am attaching our answers to your questions for the record from the Subcommittee's May 5 secondary mortgage market hearings. I appreciate the opportunity to respond to the matters you have raised.

The discussions we have had with your staff and representatives of the Administration since those hearings have been very fruitful. While we have not agreed on all the issues, I believe each of us has a better understanding of how best to achieve our shared objective of making the secondary mortgage market work even better. I know that you will carefully review all of our answers, but I wanted to draw your attention particularly to our answer to question two, as it describes what we believe is the best method of achieving those shared objectives.

Thank you again for the opportunity to respond to your questions. We look forward to continuing to work with the Subcommittee and its staff to assure that an active secondary mortgage market serves the needs of America's homebuyers.

Sincerely,

David Maxwell

DOM/lc
attachment

Question 1 A. Would it be correct to conclude that the provision permitting Fannie Mae to directly guarantee mortgage pools issued by private lenders would have the effect of excusing that lender from the need to register the issue?

Answer: FNMA's proposed authority to guarantee the issues of others would exempt lenders using the program from the need to register their FNMA-guaranteed securities. Lenders have various options for selling mortgages into the secondary market without registration. For example, lenders may sell loans to FNMA or FHLMC directly, sell the loans to conduit mortgage-backed security (MBS) issuers such as the Mortgage Guaranty Insurance Corporation (MGIC), privately place the loans with other lenders or investors, or -- in the case of FHA/VA mortgages -- issue GNMA securities.

A compilation by the investment banking firm of Lepercz, de Neuflize & Company indicates that only about 100 mortgage originators have elected to issue their own publicly traded and registered securities. The fundamental issue confronting a lender seeking to sell its mortgage production through an MBS is not registration. Rather, the issue is the value of the guarantee and the liquidity needed to provide investors in the security the assurance of ready markets for their investments. That is, by pooling loans from a number of originating lenders, firms operating in the secondary market can achieve volume, liquidity and dispersion of default risk. In turn, bid/ask spreads narrow, Wall Street broker/dealers are able to make markets in the securities and effective links to the capital markets are created. Liquidity, volume and the value of our guarantee provide lower mortgage interest rates for homebuyers. FNMA's legislative request to guarantee the securities of others is no more than one further step in the evolution toward more efficient markets for housing credit and no different than the guarantee program and procedure offered by GNMA.

Question 1B. In your view, if a given lender had a pool of mortgages to sell and could choose between selling it with a Fannie Mae guarantee or insurance through RFC or G.E. Credit, would the lender really have any choice economically given the "agency" effect of your guarantee?

Answer Any lender with a pool of mortgages to sell has many options from which to choose. If, for example, the loans were issued under FHA or VA programs, the lender would be likely to pool them using a GNMA security program and sell them into the marketplace. In this case, the GNMA guaranty would provide the best price for the lender, a price which neither FNMA, FHLMC, RFC, nor G. E. Credit would be likely to match.

If a lender had conventional loans to sell, additional options would be available. The lender might sell whole or participation loans directly to another lender, with or without assistance from a broker or intermediary. Approximately half of the secondary market transactions are handled this way.

Absent a direct sale of this type, the lender would look at prices for various types of loans offered by competitors in the secondary market. For mortgages with balances in excess of $108,300, the lender could look to firms such as RFC and G. E. Credit, since FNMA and FHLMC are prohibited from the purchase or guarantee of such loans. As with conforming conventional loans, i.e., under $108,300, most loans over that size are sold on a whole or participation basis to other lenders and investors such as life insurance companies. These loans are attractive investments because they command a higher interest rate, therefore, higher yield to the investor, with lower loan-to-value ratios and, thus, less risk of mortgage default.

Since "nonconforming" loans account for 25 percent of mortgage originations, it is a very sizable market. Within this protected market, however, only a small percentage of the eligible loans have been placed into securities, so lenders usually have been selecting other choices available to them.

For loans below the $108,300 threshold, lenders have an additional set of choices. They can sell the loans to FNMA, FHLMC or firms such as RFC or G. E. Credit. These would include conventional single-family loans (fixed-rate or adjustable), manufactured housing loans, second mortgages and multifamily loans although RFC and G.E. Credit will not buy loans on manufactured housing, and only few condominiums and townhouses. Even among the secondary market firms with agency status, lenders have several choices. FHLMC, for example, is tax-exempt. Hence, it can maintain profit levels comparable to FNMA while offering better prices to lenders, since FNMA is fully taxable.

FNMA, on the other hand, can purchase loans for its portfolio or can guarantee pools of loans used as collateral for securities. These are two very different businesses. During periods when interest rates are high and continuing to trend upward, mortgage-backed securities with current coupon loans become relatively less attractive to investors. This is when portfolio services are especially important in support of housing, as FNMA demonstrated during 1982 when it purchased over $15 billion in mortgages for its portfolio, or one of every seven loans originated that year.

With respect to choosing between a FNMA or FHLMC guarantee and pool insurance offered through RFC or G. E. Credit, the economic choice is generally to sell the pool of mortgages to FNMA or to FHLMC. FNMA and FHLMC provide a valuable service -- guaranteeing the timely payment of principal and interest -- at a low price. This results in a pricing advantage for FNMA and FHLMC securities relative to those of other firms, which translates directly into lower mortgage rates for the homebuyer. That is why FNMA and FHLMC were created with characteristics which the market regards as conferring agency status.

Question 2. One of the witnesses stated that the passage of amendments sought by FNMA should be "tied to the setting of a definite schedule for the weaning of FNMA from the federal government". He states that this process ought to take place as a joint consultation between FNMA and HUD under the supervision of the relevant congressional committee. What is your response to this proposal?

Answer: A joint consultative process is desirable. We have been meeting for almost three months with representatives of the Administration and your staff to discuss a number of these issues.

As we have explained to them, privatizing FNMA by stripping its agency attributes one by one or by setting a definite timetable for FNMA to become fully private would be disastrous. The perception in the investment community -- even if a specific timetable is not set -- would be that losing a particular agency attribute is the first step in losing all of them. From that day, FNMA would have an extremely difficult time borrowing long term, one of the vital strategies we must pursue if we are to reduce the significant imbalance between the maturities of our assets and liabilities. Since we have to roll over approximately $22.6 billion in debt during the next 12 months, the financial effect on FNMA would be enormous. And, since agency status is conferred by the market and not by our Charter Act, one cannot legislate a gradual and controlled diminution of agency status. For these reasons, we strongly believe that "the setting of a definite schedule for the weaning of FNMA from the federal government" would hurt us financially, significantly impair our ability to continue providing mortgage credit and result in higher mortgage rates for homebuyers. For these reasons, we would vigorously oppose any such proposal.

Our legislative amendments were designed to help us better serve homebuyers and the mortgage market, as well as provide us with the financial tools to correct our very significant mortgage portfolio problem, a problem demonstrated by the fact that we inherited a $52 billion portfolio yielding 9.23%. While the $22.6 billion in mortgages we purchased from January, 1981 through June, 1983 help offset the significant losses on this inherited portfolio, as of June 30, 1983, the total portfolio was still losing roughly $300 million on an annualized basis. Passage of these amendments should not be tied to a phaseout of our agency characteristics. This could have a significantly adverse impact on our ability to support the mortgage market by raising the interest rates we must pay to borrow funds to finance the purchase of mortgage loans. This, coupled with the fact that banks and thrifts own approximately two-thirds of FNMA's $75 billion of outstanding debt, makes perceived stripping of agency characteristics unwise public policy.

For FNMA to become more private means that we could borrow funds to purchase mortgages and guarantee pools of such loans on the basis of our own credit, not on our agency status. Therefore, we have proposed to the Administration and your staff a method for FNMA to achieve this goal. In return for support of our legislative requests -- which will accelerate our ability to borrow on our own credit -- we would agree to a set of financial benchmarks which, when achieved, would permit us to borrow funds as any other private company and would allow us to give up our agency status, secure in the knowledge that we could continue to support the mortgage market and low-and moderate-income homebuyers -- without the fear that we could not borrow funds in the capital markets to carry out these purposes.

Discussions are actively under way on defining what these benchmarks should be and how our progress in achieving them should be monitored. As I said, representatives of the Administration and your staff are involved in these discussions. While these negotiations involve difficult issues, we believe that over the next several months we can agree on a set of financial benchmarks which, as they are achieved, will permit FNMA to borrow funds on its own credit. We would be pleased to work closely with you and other members of the Subcommittee, as well as the Subcommittee staff, in defining these benchmarks.

Question 3. One witness asserted very forcefully that the elimination of lending limits for Fannie Mae and Freddie Mac will effectively exclude private competitors from the mortgage-backed securities packaging business, and preclude private sector involvement in the development of a secondary mortgage securities market. You say in your testimony that there is plenty of room for everyone to have a share of the market. Yet, assuming the Charter Act lending limits are increased, how do you expect private entities to compete with federally-sponsored agencies which can, first, sell their securities at a yield significantly below that obtainable by private entities with an S & P AAA rating; and second, have an exemption from S.E.C. securities registration requirements?

Answer: Since 1976 nearly $8 billion of "private" securities backed by mortgage pools have been issued. These private securities were issued primarily by mortgage companies, depository institutions, homebuilders, and affiliates of mortgage credit insurance companies. The annual volume of these private, mortgage-backed securities not guaranteed by GNMA, FNMA, or FHLMC rose dramatically from $27 million in 1976 to $2.4 billion in 1982. (These data, summarized in Table 1, are derived from statistics compiled by Lepercq de Neuflize & Co., which were further expanded by an unpublished survey by the Department of HUD and a follow-up survey by FNMA.)

Part of the $8 billion in private mortgage-backed securities are secured by mortgages below the FNMA/FHLMC mortgage limit -- that is, mortgages in pools in direct competition with FNMA/FHLMC mortgage-backed securities. For example, the $64.2 million mortgage-backed securities issued by General Electric Mortgage Securities Corporation in February 1983 were used to finance loans that, we are advised, typically had a balance of about $70,000. In the case of the mortgages financed by Norwest Mortgage Inc. (formerly known as Banco) through the issuance of conduit mortgage pass-through securities, we are also advised that the average loan amount through June 30, 1983 was about $95,000, including relocation loans which averaged about $77,000. These average mortgage amounts are below the existing FNMA and FHLMC limits.

Moreover, the growth opportunity for private mortgage-backed securities above FNMA's proposed new mortgage limits is even more substantial. FNMA and FHLMC have projected to Congress, following our testimony in the spring of 1983, that increasing the FNMA and FHLMC mortgage limits in accordance with the HUD high cost formula -- as currently proposed in our modified legislative request -- would result in a "non-conforming" loan market equal to 17% of total new mortgage originations. Applying this market share to our estimate of the total market in 1984 of $210 billion suggests that a $36 billion market would be available exclusively to issuers of mortgage-backed securities other than GNMA, FNMA or FHLMC -- a market potential more than 14 times the actual volume of mortgage-backed securities issued by such institutions in 1982.

Moreover, the opportunities for private companies to participate in secondary mortgage market purchases extend well beyond the securities business. The total secondary market activity, 1970-82, is illustrated in Exhibit 1 for the two components of the secondary market other than the Federal government:

- FNMA and FHLMC, excluding "swaps";
- All other participants, excluding FNMA, FHLMC and Federal government (primarily GNMA and Farmers Home Administration).

Although the total purchases, excluding "swaps," for FNMA/FHLMC increased in the 1977-82 period over prior years, FNMA/FHLMC combined have averaged only 22% of the secondary market for 1-4 family home mortgages over the entire 1970-82 period (see Table 1). Furthermore, FNMA/FHLMC did not increase their 22% average market share in the 1977-82 period despite FNMA/FHLMC mortgage limits increasing 94% from $55,000 to $107,000.

In summary, the secondary market is large enough so that there is ample opportunity for private entities to have a share of that market if they choose to participate. The combined market share, 1970-82, for all participants in the secondary market, exclusive of FNMA/FHLMC and the Federal government, has averaged 45% -- twice the size of the market for FNMA and FHLMC combined. The argument that increased FNMA/FHLMC mortgage limits would prohibit participation by private institutions in the secondary market is simply not supportable by the facts. Quite the contrary, as the data clearly demonstrate, there has been and will continue to be a large private secondary market for "conforming" loans, beyond the activity of FNMA and FHLMC. And the market for "non-conforming" loans -- assuming passage of FNMA's legislative request, as modified -- would offer an opportunity for a 13-fold increase over the 1982 levels for private mortgage-backed security issuers.

The issue of required yields for FNMA and FHLMC securities and those rated AAA by S & P is more difficult to quantify than market size and shares. Clearly, however, FNMA and FHLMC have some advantage because of their perceived agency status. This advantage translates directly into lower mortgage interest rates for homebuyers. Removing these advantages would cause less funds to flow into mortgages and would result in higher mortgage interest rates.

TABLE 1

SECONDARY MARKET PURCHASES OF 1-4 FAMILY MORTGAGE LOANS

(Dollars in Millions)

				Federal							
	Depositories & Other Financial	Private		Federal Agencies(c)	Guaranteed Mortgage Pools		Federal	Sponsored Agencies (Own Account & Mortgage Pools)(d)		FNMA/FHLMC	
Year	Institutions(a)	Pools(b)	Subtotal	(Own Account)	GNMA	FmHA	Subtotal	FNMA(e)	FHLMC(f)	Subtotal	Total(g)
	(1)	(2)	(1)+(2)	(4)	(5)	(6)	(4)+(5)+(6)	(8)	(9)	(8)+(9)	(10)
1970	$6,194	-	$6,194	$116	$452	$1,492	$2,060	$4,777	$357	$5,134	$13,388
1971	10,613	-	10,613	103	2,701	1,095	3,899	2,742	747	3,489	17,999
1972	15,324	-	15,324	1,024	2,487	1,953	5,464	2,596	1,218	3,814	24,602
1973	10,997	-	10,997	1,525	2,670	1,226	5,421	4,170	1,282	5,452	21,870
1974	7,932	-	7,932	1,412	4,298	1,965	7,675	4,746	2,174	6,920	22,527
1975	9,992	-	9,992	5,097	7,232	3,234	15,563	3,646	1,713	5,359	30,914
1976	16,899	27	16,926	4,779	13,092	1,820	19,691	3,337	1,122	4,459	41,076
1977	22,983	255	23,238	111	16,736	2,686	19,533	4,650	4,072	8,722	51,493
1978	20,973	888	21,861	118	14,606	3,609	18,333	12,302	6,493	18,795	58,989
1979	27,623	1,763	29,386	118	24,032	2,286	26,436	10,798	5,594	16,392	72,214
1980	28,869	994	29,863	151	19,719	5,462	25,332	8,074	3,640	11,714	66,909
1981	23,395	1,465	24,860	177	13,342	4,158	17,677	6,111	1,425	7,536	50,073
1982	31,624	2,439	34,063	163	14,792	4,367	19,322	15,712	2,769	18,481	71,866

Percent Distribution

Year											
1970	46.3%	.0	46.3%	.9%	3.4%	11.1%	15.4%	35.7%	2.7%	38.3%	100.0%
1971	59.0%	.0	59.0%	.6%	15.0%	6.1%	21.7%	15.2%	4.2%	19.4%	100.0%
1972	62.3%	.0	62.3%	4.2%	10.1%	7.9%	22.2%	10.6%	5.0%	15.5%	100.0%
1973	50.3%	.0	50.3%	7.0%	12.2%	5.6%	24.8%	19.1%	5.9%	24.9%	100.0%
1974	35.2%	.0	35.2%	6.3%	19.1%	8.7%	34.1%	21.1%	9.7%	30.7%	100.0%
1975	32.3%	.0	32.3%	16.5%	23.4%	10.5%	50.3%	11.8%	5.5%	17.3%	100.0%
1976	41.1%	.1%	41.2%	11.6%	31.9%	4.4%	47.9%	8.1%	2.7%	10.9%	100.0%
1977	44.6%	.5%	45.1%	.2%	32.5%	5.2%	37.9%	9.0%	7.9%	16.9%	100.0%
1978	35.6%	1.5%	37.1%	.2%	24.8%	6.1%	31.1%	20.9%	11.0%	31.9%	100.0%
1979	38.3%	2.4%	40.7%	.2%	33.3%	3.2%	36.6%	15.0%	7.7%	22.7%	100.0%
1980	43.1%	1.5%	44.6%	.2%	29.5%	8.2%	37.9%	12.1%	5.4%	17.5%	100.0%
1981	46.7%	2.9%	49.6%	.4%	26.6%	8.3%	35.3%	12.2%	2.8%	15.1%	100.0%
1982	44.0%	3.4%	47.4%	.2%	20.6%	6.1%	26.9%	21.9%	3.9%	25.7%	100.0%
Averages											
1970-82	44.5%	.9%	45.5%	3.7%	21.7%	7.0%	32.5%	16.3%	5.7%	22.1%	
1977-82	42.1%	2.0%	44.1%	.2%	27.9%	6.2%	34.3%	15.2%	6.4%	21.6%	

a/ S&Ls, banks, mortgage companies, state/local agencies, pension funds and REITs

b/ Mortgages purchased by mortgage pools other than GNMA, FmHA, FNMA, or FHLMC.

c/ GNMA, FHA, SBA, VA; excludes purchases by Farmers Home Administration (FmHA)

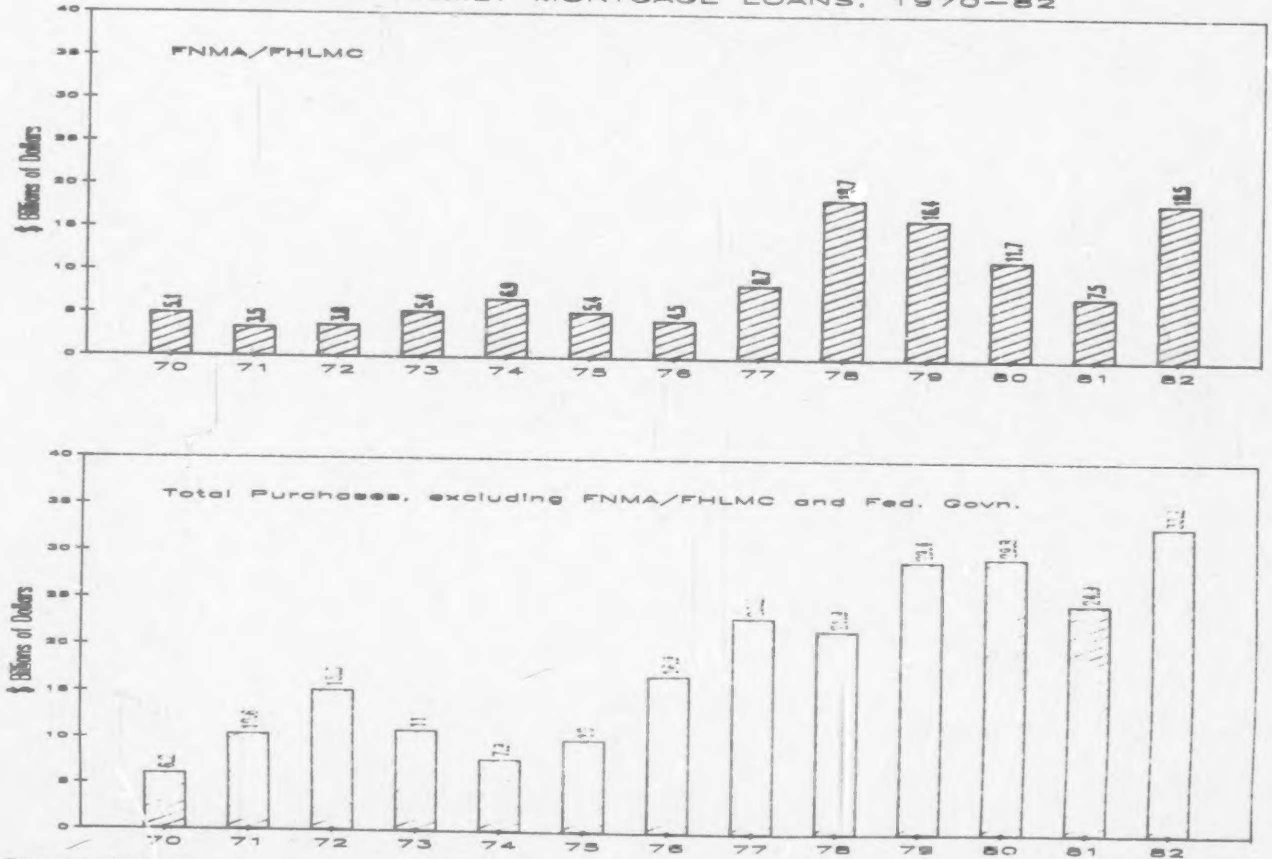
d/ Net Purchases for own account plus purchases by agencies' mortgage pools

e/ Excludes swaps: $717(1981); $9,823 (1982)

f/ Excludes swaps: $2,201(1981); $21,056(1982)

g/ Total column is not fully equivalent to HUD published series because of [illegible] refinements to data for GNMA, FNMA, FHLMC and private MBS pools.

EXHIBIT 1
SECONDARY MARKET PURCHASES
OF 1—4 FAMILY MORTGAGE LOANS, 1970—82



Source: Table 1

Question 4. One of Fannie Mae's amendments would allow the Association to invest in nonresidential commercial real estate, such as shopping centers, office buildings, industrial plants and other commercial facilities.

Is there today a shortage of private capital available for the development of nonresidential commercial real estate?

If private capital is taking care of commercial real estate, what is the justification for providing government subsidized FNMA programs?

Answer: The amendment FNMA proposed would limit FNMA's activity in nonresidential real estate to a small percentage of its previous years' mortgage purchase activity, i. e., 5% in the first year and 10% in the following years. The amendment also specifically limits FNMA purchases to only those nonresidential mortgages that serve the needs of residential subdivisions, neighborhoods, and housing projects; we do not intend to finance central city office buildings, industrial plants or other commercial facilities that do not directly serve the needs of residential areas.

Funds for financing commercial projects typically associated with residential construction exhibit rate sensitivities and an on-again/off-again cycle, much the same as residential housing. This phenomenon is confirmed by builders and developers of residential planned unit developments (PUDs), mixed use developments and inner city neighborhood projects. By contrast, large commercial projects divorced from housing have greater access to funds from insurance companies, pension funds and other large investors seeking equity interests in large urban developments. FNMA has not sought to purchase mortgages on these types of projects.

Since private sources of capital are not adequately serving the small, nonresidential real estate market, particularly in those markets other than the major metropolitan areas, we have proposed being permitted to serve this market.

We do not believe, in any sense, that permitting FNMA to do so would be equivalent to a government-subsidized program.

As you know, FNMA uses no appropriated funds and borrows funds directly in the capital markets to finance its purchase of mortgages.

FNMA also seeks authority to purchase nonresidential mortgages in order to better match its assets and liabilities. These mortgages typically have short-term maturities or can be structured as variable rate mortgages. Allowing a portion of FNMA's portfolio to consist of matched assets and liabilities, producing a predictable flow of income to offset the unstable rate sensitive residential mortgage assets, will lower the perceived riskiness of FNMA and allow it to provide lower mortgage rates for homebuyers. Thus, this proposal would benefit homebuyers, would help FNMA in its efforts to support the mortgage market and would not do so at the expense of private sources of capital.

Question 5. Concern has been expressed that banks are reluctant to lend on cooperative apartments and there is no secondary market for such loans. It also appears that the same situation prevailed for condominium units prior to 1961 when the National Housing Act was amended to include these condominium units. Although the tax trend has been to treat the cooperator's interest as realty, the fact that corporate stock is involved continues to give the interest a status of personal property. I would like your views on whether or not the National Housing Act should be amended to provide mortgage insurance for cooperatives and the Charters of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation to provide a secondary market for cooperative paper.

Answer: Our response focuses on that part of the question concerning FNMA. Section 313 (a) of the Housing and Community Development Act of 1980, Public Law 96-399, defines the term "conventional mortgages," as used in the FNMA Charter Act, to include mortgages, liens, or other security interest on the stock or membership certificates issued to tenant stockholders or resident members of cooperative housing corporations. For this reason, it does not appear that the FNMA Charter Act requires further amendment in order to authorize the corporation to provide a secondary market for loans on cooperative apartments.

THE URBAN INSTITUTE [illegible]

July 19, 1983

Senator John Tower
UNITED STATES SENATE
Subcommitee on Housing
  and Urban Affairs
Washington, D.C. 20510

Dear Senator Tower:

In response to your letter of June 24th, I would propose the following response to your question:

> The elimination of the ties between FNMA and the government ought to be determined by collaboration between FNMA, HUD and the Congress. Such elimination ought to be contingent on a sustained record of profitability by FNMA and be done in such a way as to minimize the disruption caused to stockholders and customers. Initial steps would be the following:
>
> 1) Restructure of FNMA's portfolio to reduce the dependence on fixed rate loans. This would lower the probability that future interest rate increases would have the effect on FNMA they had in the most recent cycle.
>
> 2) Reduction in the level of the Treasury backstop to FNMA. This line of credit is unused now and could be phased out gradually to reassure financial markets that FNMA debt was indeed sound and ought to be rated according to standard market norms.
>
> 3) Attachment to FNMA debt of a rating from one of the standard rating services, as a substitute for the government tie. During a transition period, such a rating would dominate as market information when the Treasury backstop was eliminated.
>
> The timing of these steps would be open to negotiation, but the full process should be accomplished over an eighteen month period. My own preference would be to target the process to begin in mid-1984 and be finished by the beginning of 1986.

It was a pleasure to appear before your committee and I hope my testimony and this answer proves helpful. If you need services again, please do not hesitate to call.

Sincerely,

John Tuccillo

John Tuccillo
Director, Center for Housing
  and Community Development Research

AFTERNOON SESSION

Senator **Proxmire** [presiding]. This is panel 2, consisting of Barbara Hallbauer, Dennis Dammerman, Marvin Gilman, Stuart Davis, Leon Kendell, and Felix Beck.

We're delighted to have you folks. As you know, I'm a member of the minority. It means that I only chair in absolute emergencies.

Senator Heinz will be coming back shortly, but they've asked me to ask you to go ahead, so we can proceed.

We apologize for any delay. Miss Hallbauer, go ahead.

Pardon me, I understand I was wrong in saying Dennis Dammerman. It's Mr. Robert Green; is that correct?

Mr. **Green**. That's correct, Senator.

STATEMENT OF BARBARA HALLBAUER, EXECUTIVE VICE PRESIDENT, NORWEST MORTGAGE, INC.

Ms. **Hallbauer**. Senator Proxmire, my name is Barbara Hallbauer, executive vice president and a member of the board of directors of Norwest Mortgage, Inc., formerly Banco Mortgage Co., and its subsidiary, Residential Funding Co.

Both firms are headquartered in Minneapolis, Minn. Norwest Mortgage originates, markets, and services residential first mortgage loans. It is the third largest mortgage banking firm in the country, servicing $8.2 billion in loans.

Residential Funding is a purchaser from other institutions of mortgage loans to be sold in the secondary market for such loans.

I appreciate the opportunity to appear and testify and to express our deep concern with the Fannie Mae and Freddie Mac request that the current mortgage-loan ceiling of $108,300 be raised.

Such an increase in the loan ceiling would directly and substantially cut into our efforts and the efforts of other vigorous private companies to provide a competitive rather than a monopolized secondary marketplace for housing loans above the current loan ceiling.

PERPETUATE AND EXTEND GOVERNMENT MONOPOLY

We believe that to stifle the efforts of private companies by raising the loan ceiling would serve no legitimate public purpose or need. It would only serve to perpetuate and extend the already substantial Government monopoly position in the secondary market for mortgage loans, and in the already huge effective exposure of the U.S. Treasury to supporting that market.

Four months ago Norwest Mortgage, through its subsdiary, Residential Funding Corp., established a new private secondary mortgage marketplace employing a conduit system of loan purchasing and pooling of mortgage-backed securities.

Combining our efforts and those of Mortgage Guaranty Insurance Corp. and Salomon Bros., we have to date attracted 1,400 lender applicants nationwide.

Those served are largely well-to-do home buyers who have mortgage needs that substantially exceed those of low- and moderate-income Americans. They are homebuyers whose needs exceed the loan limits now placed on the Government mortgage lending agencies. They are individuals who are far from needing Government assistance.

To reach a broad network of mortgage lenders, Residential Funding has coordinated with MGIC which has approximately 40 offices around the country. MGIC in turn uses its extensive sales force to introduce the program to commercial banks, savings and loans, and mortgage bankers.

In addition, MGIC is instrumental in the underwriting of loan and offers primary insurance for individual loans, as well as pool and special-hazard insurance for conventional mortgage-backed securities.

Once Residential Funding purchases loans, it packages them into conventional mortgage-backed securities which in turn are sold into the secondary marketplace.

All our mortgages of this type carry a AA rating from Standard & Poor, and have thus far found ready market acceptability among investors. There are 350 applicant institutions already active in our program, having registered with us over $400 million in mortgage loans in our first 120 days of operation.

Due largely to the effect of private competition, we offer the public flexibility in responding to their demands for a multitude of loan types. For example, we offer low downpayment or high downpayment, adjustable rates, short maturities or long maturities, with loan amounts ranging from $30,000 to $500,000, depending upon which loan program is desired.

A detailed summary of the various loan programs offered is submitted as attachment A to my statement.

Taking into account the necessary startup time for this effort, we conservatively estimate that we will purchase during our first full year of operation approximately $5 billion in residential mortgage loans.

Our advisors on this matter from Salomon Brothers have indicated that the market exists for issuance of mortgage-backed securities, and we have already begun selling such securities under a $2-billion shelf-registration filed with the Securities and Exchange Commission.

Prior to the birth of Residential Funding, the only established way for lenders to access the secondary mortgage market was through the two quasi-Government agencies, Fannie Mae and Freddie Mac.

They had a monopoly. Now, for the portion of the home mortgage market above the present loan ceiling, there is competition.

It is our understanding that the Government mortgage lending institutions were created by Congress to provide a constant source of funds from the secondary market for mortgage of low and moderate amounts.

It was initially the intent that the agencies would facilitate and encourage lending institutions to make mortgage loans to the less economically advantaged.

This focus on the needs of those with low and moderate incomes was to be insured by imposing a statutory ceiling on mortgage loan size. For mortgages over such a ceiling it was not considered necessary to provide Government assistance.

Although that was the objective, over time the loan ceiling has gradually increased, so that today approximately 88 percent of all mortgage loans fall below the ceiling.

At its present level of $108,300, it may already exceed the objective of providing help only for low- and moderate-income families.

It is only the remaining 12 percent of the residential mortgage market, which serves upper income buyers, that Residential Funding asks you to leave to private sector competition.

If the loan ceilings are raised, competition will be stifled because private concerns will be unable to compete against quasi-Government agencies backed by the U.S. Treasury.

AGENCIES AFFORDED SPECIAL ADVANTAGES

Those agencies were, upon their creation, afforded special advantages to assist them in providing a secondary market for the home mortgages of low and moderate income families.

One such advantage is their ability to incur debt at preferred rates because the market perceives them as arms of the Government and because they are by law supported by the U.S. Treasury. As reflected in attachment B, this provides FNMA with a significant capital cost advantage over private firms.

Even during 1982, a year when the agencies' financial condition was less robust than in the past, they were able to borrow funds at rates below those for private companies that carried a AAA rating.

Although U.S. Treasury exposure on FNMA loans is limited by law to $2.25 billion, the FNMA and FHLMC cost advantage derives primarily from the widespread perception in the marketplace that as a practical matter the Federal Government would, if it were necessary, underwrite any losses the agencies sustained and be available to cover all the paper they have issued.

This impression is not the product of law, but of commonsense. It is reasoned that without Government intervention in a crisis, the mortgage market would collapse. It is also thought that the Government would have to support the lending activities of its own agencies, and could not allow them to default.

As a result, to date the total perceived exposure of the Government equals the $73 billion in home loans for which FNMA has assumed responsibility. Even within the limits of the current loan ceiling, that perceived commonsense Government exposure will no doubt increase substantially in coming years.

If, in addition, Congress were to grant the agencies' current request for yet higher loan limits, perceived Government exposure would be expanded still further.

At the same time, such an increase in the loan ceiling would extend the FNMA and FHLMC monopoly to yet a higher income level because private firms like ours could not compete if the agencies were in the market.

So long as they have Government support, they will be able to outprice us.

Ironically, both of the Government agencies have stated that they would encourage, even give incentives, to encourage private companies to enter the secondary market for housing.

Such encouragement will be meaningless if, by increasing the loan ceilings, private businesses were driven out.

Senator Proxmire, our concern is thus not with the current functions of FHMA and FHLMC, nor with a national housing policy that encourages homeownership.

Our concern is that quasi-governmental organizations with limited public policy objectives now seek to move far beyond their chartered area of responsibility and carry their substantial special advantages into a private sector marketplace where, because of their quasi-governmental status, they will have a significant competitive edge.

In thus seeking to expand their monopoly and the huge effective Government exposure that supports it, we believe that Fannie Mae and Freddie Mac should carry a heavy burden of proof.

They must show, we believe, that such an extension of their activities is truly in the public interest. We do not believe they can meet that burden.

Proponents of the loan-ceiling increase have, of course, advanced a number of arguments in support of such an increase. We do not believe that by those arguments they have carried their burden of proof.

One primary argument that has been advanced is that the Government agencies need the increase in loan limits to preserve their profitability and to avoid serious losses, so they may serve low and moderate income groups more effectively.

I would urge that this argument is unpersuasive for at least two reasons. First, FNMA first quarter profits of $15 million show that its recent bout with unprofitability was nothing more than a short-term product of hard times.

Its generally profitable history and the recent restoration of its profits after a relatively brief interruption suggests no need whatever for a Government commitment aimed at making it still more profitable.

Second, I would not see the pursuit of larger Government agency profits as a suitable reason to increase the already huge exposure of the Treasury.

Indeed, if there is truly a risk of losses, then Treasury exposure in support of FNMA and FHLMC should probably be reduced, not increased.

A further argument of those supporting a loan ceiling increase is that there is a need for the Government to serve specified high-price housing areas where mortgage needs now exceed the loan ceiling.

As to this argument, you should be aware that the data from the Federal Home Loan Bank Board appears to indicate that in such high-cost areas—for example, the New York-Connecticut area, Los Angeles, San Francisco, and here in Washington—the average conventional loan size for all major lenders can be served within the limits of the present loan ceiling.

In support of my point, I have submitted as attachment C to this statement, a table reflecting the average loan sizes for selected high-cost areas based on Federal Home Loan Bank Board figures.

A further point is that if there was a need for a Government-assisted secondary marketplace for larger loans than those high-priced areas, one would expect to find the two quasi-Government organizations would now be purchasing a large number of loans in the range very close to the current ceiling.

But that does not appear to be the case. According to Mortgage Data Services statistics, FNMA and FHLMC loan sizes are on the average $22,000 and $43,000 below the $108,300 ceiling.

Another point to consider—and it is probably the most important—is that those borrowers in the high-priced areas are in a position to use the private secondary market and, therefore, do not need Government assistance.

If they do not need help, why should the Government extend its exposure to provide them with assistance?

Finally, it is also worth emphasizing that those in higher income brackets receive a greater benefit from tax deductions than those in lower brackets.

That they may not also receive Government assistance, permitting them to borrow at lower interest rates should, therefore, not be a matter of concern. Lower rates may be desired by many interests for their own monetary benefit.

But the question remains, at what point is there truly a need for a Government subsidy and why not use it in other areas of our economy, where the private sector is not willing or able to take risks?

Another argument advanced by some in support of the loan ceiling increase is that the private sector may not have the staying power necessary to remain active in the market during difficult economic times.

For ourselves, we have a long history of commitment to the mortgage banking business, over 70 years. Over this period we have fulfilled our commitments and developed a strong financial position that we believe will more than sustain us in the secondary market for mortgage loans.

We also expect that other competitors in the private market will be strong financial institutions with ample strength to weather changes in our economy.

I would also question very seriously the argument that a Government financial monopoly should be substituted because in a doomsday situation private firms might not be able to cope.

Senator Proxmire, in making its decision with respect to the FNMA and FHLMC loan ceiling, we urge the committee to consider the needs, the risks and the costs associated with the proposal, to consider the role of the private secondary market can play and think in terms of the long-range effects of competition versus monopoly.

I thank you, sir, and the committee for the time allotted me today.

[The complete statement and response to questions follow:]

STATEMENT OF

BARBARA A. HALLBAUER

Executive Vice President
NORWEST MORTGAGE, INC.
AND
RESIDENTIAL FUNDING CORPORATION

Banco Mortgage Company

Mr. Chairman, my name is Barbara Hallbauer. I am the Executive Vice President and a member of the Board of Directors of Norwest Mortgage, Inc. (formerly Banco Mortgage Company) and its subsidiary Residential Funding Corporation. Both firms are headquartered in Minneapolis, Minnesota. Norwest Mortgage originates, markets and services residential first mortgage loans. It is the third largest mortgage banking firm in the country, servicing $8.2 billion in loans. Residential Funding is a purchaser from other institutions of mortgage loans to be sold in the secondary market for such loans.

I appreciate the opportunity to appear and testify and to express our deep concern with the FNMA and FHLMC request that their current mortgage loan ceiling of $108,300 be raised. Such an increase in the loan ceiling would directly and substantially cut into our efforts and the efforts of other vigorous private companies to provide a competitive rather than a monopolized secondary marketplace for housing loans above the current loan ceiling. We believe that to stifle the efforts of private companies by raising the loan ceiling would serve no legitimate public purpose or need; it would serve only to perpetuate and extend the already substantial government monopoly position in the secondary market for mortgage loans and the already huge, effective exposure of the U.S. Treasury in supporting that market.

Four months ago, Norwest Mortgage, through its subsidiary, Residential Funding Corporation, established a new private secondary mortgage marketplace employing a conduit system of loan purchasing and pooling of mortgage-backed securities. Combining our efforts and those of Mortgage Guaranty Insurance Corporation (MGIC) and Salomon Brothers, we have to date attracted 1,400 lender applicants, nationwide. Those served are largely well to do home buyers who have mortgage needs that substantially exceed those of low and moderate income Americans. They are home buyers whose needs exceed the loan limits now placed on the government mortgage lending agencies. They are individuals who are far from needing government assistance.

To reach a broad network of mortgage lenders Residential Funding has coordinated with MGIC which has approximatley 40 offices around the country. MGIC in turn uses its extensive sales force to introduce the program to commercial banks, savings and loans and mortgage bankers. In addition, MGIC is instrumental in the underwriting of loans and offers primary insurance for individual loans as well as pool and special hazard insurance for conventional mortgage backed-securities. Once Residential Funding purchases loans, it packages them into conventional mortgage backed securities which in turn are sold into the secondary marketplace. All our mortgages of this type carry a AA rating from Standard and Poor, and have thus far found ready market acceptability among investors. Three hundred and fifty applicant institutions are already active in our program, having registered with us over $400 million in mortgage loans in our first 120 days of operation.

Due largely to the effect of private competition, we offer the public flexibility in responding to their demands for a multitude of loan types. For example, we offer low downpayment or high downpayment, adjustable rates, short maturities or long maturities with loan amounts ranging from $30,000 to $500,000 depending upon which loan program is desired. A detailed summary of the various loan programs offered is submitted as Attachment A to my statement.

Taking into account the necessary start-up time for this effort, we conservatively estimate that we will purchase during our first full year of operations approximately $5 billion in residential mortgage loans. Our advisors on these matters from Salomon Brothers have indicated that the market exists for issuance of mortgage-backed securities and we have already begun selling such securities under a $2 billion shelf registration filed with the Securities and Exchange Commission.

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It is our understanding that the government mortgage lending institutions were created by the Congress to provide a constant source of funds from the secondary market for mortgages of low and moderate amounts. It was initially the intent that the agencies would facilitate and encourage lending institutions to make mortgage loans to the less economically advantaged. This focus on the needs of those with low and moderate incomes was to be insured by imposing a statutory ceiling on mortgage loan size. For mortgages over such a ceiling it was not considered necessary to provide government assistance.

Although that was the objective, over time the loan ceiling has gradually increased so that today approximately 88 percent of all mortgage loans fall below the ceiling. At its present level of $108,300 it may already exceed the objective of providing help only for low and moderate income families.

It is only the remaining 12 percent of the residential mortgage market, which serves upper income buyers, that Residential Funding asks you to leave to private sector competition. If the loan ceilings are raised, competition will be stifled because private concerns will be unable to compete against quasi-government agencies backed [illegible]y the U.S. Treasury. Those agencies were, upon their creation, afforded special advantages to assist them in providing a secondary market for the home mortgages of low and moderate income families. One such advantage is their ability to incur debt at preferred rates because the market perceives them as arms of the government and because they are by law supported by the U.S. Treasury. As reflected in Attachment B, this provides FNMA with a significant capital cost advantage over private firms. Even during 1982, a year when the agencies' financial condition was less robust than in the past, they were able to borrow funds at rates below those for private companies that carried a AAA rating.

Although U.S. Treasury exposure on FNMA loans is limited by law to $2.25 billion, the FNMA and FHLMC cost advantage derives primarily from the widespread perception in the marketplace that as a practical matter the federal government would, if it were necessary, underwrite any losses the agencies sustained and be available to cover all the paper they have issued. This impression is not the product of law but of common sense. It is reasoned that without government intervention in a crisis the mortgage market would collapse. It is also thought that the government would have to support the lending activities of its own agencies and could not allow them to default.

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At the same time such an increase in the loan ceiling would extend the FNMA and FHLMC monopoly to yet a higher income level because private firms like ours could not compete if the agencies were in the market. So long as they have government support they will be able to outprice us.

Ironically, both of the government agencies have stated that they would encourage, even give incentives to encourage private companies to enter the secondary market for housing loans. Such encouragement would be meaningless if by increasing the loan ceilings private businesses were driven out.

Mr. Chairman, our concern is thus not with the current functions of FHMA and FHLMC, nor with a national housing policy that encourages home ownership. Our concern is that quasi-government organizations with limited public policy objectives now seek to move far beyond their chartered area of responsibility and carry their substantial, special advantages into a private sector marketplace where because of their quasi-government status they will have a significant competitive edge. In thus seeking to extend their monopoly and the huge effective government exposure that supports it, we believe that FNMA and FHLMC should carry a heavy burden of proof. They must show - we believe - that such an extension of their activities is truly in the public interest. We do not believe they can meet that burden.

Proponents of the loan ceiling increase have, of course, advanced a number of arguments in support of such an increase. We do not believe that by those arguments they have carried their heavy burden of proof.

One primary argument that has been advanced is that the government agencies need the increase in loan limits to preserve their profitability and avoid serious losses so that they may serve low and moderate income groups more effectively. I would urge that this argument is unpersuasive for at least two reasons. First, FNMA first quarter profits of $15 million show that its recent bout with unprofitability was nothing more than a short term product of hard times. Its generally profitable history and the recent restoration of its profits after a relatively brief interruption suggest no need whatever for a government committment aimed at making it still more profitable. Second, I would not see the pursuit of larger government agency profits as a suitable reason to increase the already huge exposure of the Treasury. Indeed, if there is truly a risk of losses then Treasury exposure in support of FNMA and FHLMC should probably be reduced, not increased.

A further argument of those supporting a loan ceiling increase is that there is a need for the government to serve specified high priced housing areas where mortgage needs now exceed the loan ceiling. As to this argument you should be aware that data from the Federal Home Loan Bank Board appear to indicate that in such high cost areas -- for example, New York-Connecticut, Los Angeles, San Francisco, and Washington, D.C. -- the average conventional loan size for all major lenders can be served within the limits of the present loan ceiling. In support of my point, I have submitted as Attachment C to this statement a table reflecting the average loan sizes for selected high cost areas based on Federal Home Loan Bank Board figures. A further point is that if there was a need for a government assisted secondary marketplace for larger loans in those high priced areas, one would expect to find that the two quasi-government organizations would now be purchasing a large number of loans in the range very close to the current ceiling. But that does not appear to be the case. According to Mortgage Data Services statistics, FNMA and FHLMC loan sizes are on the average $22,000 and $43,000 below the $108,300 ceiling. Another point to consider -- and it is probably the most important -- is that those borrowers in the high priced areas are in a position to use the private secondary market and, therefore, do not need government assistance. If they do not need help why should the government extend its exposure to provide them with assistance? Finally, it is also worth emphasizing that those in higher income brackets receive a greater benefit from tax deductions than those in lower brackets. That they may not also receive government assistance permitting them to borrow at lower interest rates should, therefore, not be a matter of concern. Lower rates may be desired by many interests for their own monetary benefit, but, the question remains, at what point is there truly a need for a government subsidy and why not use it in other areas of our economy where the private sector is not willing or able to take the risks.

Another argument advanced by some in support of the loan ceiling increase is that the private sector may not have the staying power necessary to remain active in the market during difficult economic times. For ourselves, we have a long history of commitment to the mortgage banking business, over 70 years. Over that period we have fulfilled our commitments and developed a strong financial position that, we believe, will more than sustain us in the secondary market for mortgage loans. We expect also that other competitors in that private market will be strong financial institutions with ample strength to weather changes in our economy. I would also question very seriously the argument that a government financial monopoly should be substituted because in a doomsday situation private firms might not be able to cope.

Mr. Chairman, in making its decision with respect to the FNMA and FHLMC loan ceiling, we urge the Committee to consider the needs, the risks and the costs associated with the proposal, to consider the role the private secondary market can play and think in terms of long range effects of competition versus monopoly.

I thank you and the Committee for the time allotted me today.

RFC Mortgage Programs

Program Name	Loan Amounts	Maximum LTV	Term	Non-Owner-Occupied	Buydowns Permanent	Buydowns Temporary	Refinances	Secondary Financing	Comments
30-Year Fixed	$30,000 to $250,000	95%	30 years	No	Yes	Yes	Yes	Yes	Loan terms of 20, 25 or 30 years are acceptable.
30-Year Fixed, Non-Owner-Occupied	$30,000 to $250,000	80%	30 years	Yes	Yes	Yes	Yes	Yes	Loan terms of 20, 25 or 30 years are acceptable.
15-Year Jumbo	$30,000 to $500,000	95%	15 years, fully amortized	No	Yes	Yes	Yes	Yes	
Conventional GPM	$30,000 to $200,000	90%	30 years	No	Yes	No	Yes	Yes	Fixed-rate mortgage with deferred interest and annual, graduated payment increases up to 7.5% for the first five years. Not available in California.
Wraparound	$30,000 to $150,000	95%	30 year max.-based on remaining term of underlying FHA/VA loan	No	No	Yes	No	No	FHA/VA underlying loans only. All wraparounds sold servicing released to RFC. Not available in California.
EOM℠	$30,000 to $250,000	90%	Approx. 13-15 years, 30-year amortization	No	Yes	No	Yes	Yes	Early Ownership Mortgage (EOM). Option of 3% or 5% constant, annual payment-growth rate. Not available in California.
STEP EOM℠	$30,000 to $250,000	95%	Approx. 16-year term, 30-year amortization	No	Yes	Yes	Yes	Yes	Short-Term Even-Payment (STEP) Early Ownership Mortgage (EOM). Level payments in years one through six. Annual payment-growth rate of 7% thereafter.
Adjustable-Rate Mortgages (ARMs)									
One-Year ARM	$30,000 to $250,000	90%	30 years, fully indexed	No	Yes	No	Yes	Yes	Indexed to one-year U.S. Treasury Securities. Full recast of rate and payments every 12 months.
Three-Year ARM	$30,000 to $250,000	90%	30 years, fully indexed	No	Yes	Yes	Yes	Yes	Indexed to three-year U.S. Treasury Securities. Full recast of rate and payments every three years. Not available in California.
Three-Year ARM, Non-Owner-Occupied	$30,000 to $250,000	80%	30 years, fully indexed	Yes	Yes	Yes	Yes	Yes	Indexed to three-year U.S. Treasury Securities. Full recast of rate and payments every three years. Not available in California.

Attachment B

1982 Cost of Debt
(Maturities vary from month-to-month, but comparable maturities used in any particular month)

	FNMA Debentures	Eurodollar CD's (AAA Commercial Banks)	U.S. Treasury
1/82	15.12%	15.50	14.68
2/82	15.72%	16.50	14.94
3/82	14.96%	15.50	13.87
4/82	15.06%	15.50	14.60
5/82	14.36%	15.13	13.54
6/82	14.68%	15.60	14.15
7/82	14.36%	15.13	13.85
8/82	14.51%	15.13	12.98
9/82	13.31%	14.50	11.58
10/82	12.18%	12.75	10.61
11/82	10.21%	11.88	10.00
12/82	11.01%	11.63	10.47

Attachment C

Selected High Cost Areas by Sales Price with 80% LTV for Existing and New Construction

	Average Loan Amounts (Per FHLBB) (A/O 12/82)
Dallas,- Fort Worth, Tx.	$ 68,400.
Los Angeles- Long Beach- Anaheim, Ca.	$100,160.
San Francisco- Oakland- San Jose, Ca.	$108,320.
Wash., D.C.- Md.-Va.	$ 87,760.
N.Y.-Conn.-N.J.	$ 86,960.

NORWEST MORTGAGE

Norwest Mortgage Inc
400 Galaxy Building
330 Second Avenue South
Post Office Box 1411
Minneapolis, Minnesota 55440
612 343 3400

July 19, 1983

Senator John Tower
United States Senate
Subcommittee on Housing and Urban Affairs
535 Dirkson
Washington, D. C. 20510

Dear Senator Tower:

Thank you for your request of June 24, 1983 to provide a response to questions which relate to the legislative proposals before the Housing Subcommittee as it relates to the secondary mortgage marketplace.

Your first question was - What percent of the mortgages you purchase are below the current limit of $108,300? The answer is approximately 9.7%. Why do you feel that you cannot compete in this sector of the market to a greater extent? The private sector's primary secondary mortgage competition for loans below $108,300 is FNMA and FHLMC. As both are perceived by the investor community as having the guaranty of the federal government, they trade their securities at rates lower that what the private sector can obtain. In addition to that advantage, there are additional costs that private issuers must bear, in the form of SEC registration expenses and pool and special hazard insurance for instance, which are necessary to provide an investor with assurances to entice him to invest in private securities when both the issuing company and collateral may be equal to or better than that which secures the government issues. The reasons we have been able to purchase any loans under $108,300 is because of the flexibility both in procedures as well as loan programs which we offer. Our programs are such as to offer a very viable market to both the smallest or the largest lending institution.

Your second question asked us to respond to FNMA's argument that they need these amendments in order to remain financially sound. It would seem that a federal housing agency's primary function should be to serve that sector of our population most in need with more creative and innovative programs rather than have as its primary concern its financial future. FNMA has recognized and is changing the flaws in its portfolio to offset future losses and has already improved its financial picture to a considerable degree. To increase its responsibilities at this point in time would both divert their efforts from regaining financial strength and serve no public need. There are other entities willing and able to increase the use of a private secondary mortgage market and their efforts should be encouraged by Congress.

Norwest Mortgage (formerly Banco Mortgage Company) thanks you for soliciting our opinion on these matters and wishes to offer any assistance to you in the future that you may need.

Very truly yours,

Barbara A. Hallbauer
Barbara A. Hallbauer
Executive Vice President

BH:sw

Senator PROXMIRE. Thank you, very much, Ms. Hallbauer.
Mr. Green.

STATEMENT OF ROBERT W. GREEN, ASSOCIATE GENERAL COUNSEL, GOVERNMENTAL OFFICES, GENERAL ELECTRIC CREDIT CORP., STAMFORD, CONN.

Mr. GREEN. Mr. Chairman, members of the subcommittee. I am Robert Green, associate general counsel for governmental and legislative affairs for General Electric Credit Corp.

I am appearing on behalf of Dennis Dammerman, who is unavoidably out of the country this week on a longstanding business commitment. I request that Mr. Dammerman's prepared statement be incorporated in the record of this hearing and I am prepared to summarize our major concerns.

Senator PROXMIRE. Without objection, that will be done.

Mr. GREEN. GE Credit appreciates the committee's decision to schedule additional time for hearings on the requests of Fannie Mae and Freddie Mac for expansion of their powers and authorities under the Charter Act and for your invitation to GE Credit to participate in these hearings.

Although many people still think of GE Credit first as a source of financing for consumer appliances, since that is where we started 51 years ago, supporting the sale of General Electric's monitor-top refrigerator, today one-third of our net receivables are related to housing activities.

GE CREDIT PORTFOLIO

At yearend 1982 GE Credit's portfolio of manufactured housing loans, commercial real estate mortgages, residential first mortgages, and second mortgages totaled \$3.5 billion in direct investments. GE Credit also services a portfolio of \$2.4 billion in mortgages and manufactured housing loans owned by unrelated investors.

In 1982, manufactured housing units comprised 28 percent of all housing units constructed in this country and approximately 1 out of every 6 manufactured housing units leaving the factory was purchased through GE Credit's inventory financing programs. We have been a major participant in both the FHA and VA-insured manufactured housing programs since their inception and continue to support construction of residential real estate through our commercial lending activities.

Last year GE Credit also rolled out our new "builder forward" program that provides builders a 12-month commitment on interest rates through the use of sophisticated financial hedging strategies. As a major diversified financial company with more than \$12 billion in assets and a AAA credit rating, GE Credit has both the financial resources and the expertise to play a significant role in the evolving secondary mortgage market.

FORCED TO JUMBO LOANS

Beginning in 1980, we have been positioning ourselves to take an active role in the development of a private sector secondary mortgage market—organizing a private mortgage insurance company in

1980, acquiring a mortgage banking subsidiary in 1981, filing a Securities and Exchange Commission shelf registration for $300 million in mortgage-backed securities in 1982, and acquiring American Mortgage Insurance Co. just 2 months ago.

Although creation of our necessary backroom facilities is not yet complete enough for a full rollout of GE Credit's new mortgage-backed securities program, we have successfully test marketed a $64 million private placement to the teacher retirement system of Texas and have written insurance on an $80 million Michigan State Housing Development Authority bond issue that earned a AAA rating, permitting the yield to investors to be reduced by one-half percent, with substantial interest savings to the authority.

In the meantime, however, Charter Act amendments have permitted Fannie Mae to roll out its own mortgage-backed securities program in October 1981, and Freddie Mac, whose sale of participation certificates dates back to 1971, also made an aggressive entry into the mortgage-backed securities market in 1981.

In view of our time pressures today, I won't go back over again the statutory advantages of Fannie Mae and Freddie Mac operating under their peculiar Charter Act status, other than to indicate that Mr. Kudlow this morning fully discussed what those advantages are, and neither Mr. Maxwell nor Mr. Thygerson disputed the facts.

There is a full discussion in our prepared statement on this issue.

In response to the Fannie Mae entry into the mortgage-backed securities market and in light of Fannie Mae's and Freddie Mac's overwhelming governmentally conferred competitive advantages, GE Credit has been forced to shift its focus to packaging so-called jumbo loans, those larger than the current Federal limit of $108,300.

These loans represent the remaining market open to the private sector, and according to a recent Home Loan Bank Board survey of 2,000 mortgage originators, the demand for residential mortgages in excess of $108,300 represents only between 6 and 8 percent of the total number of residential mortgages.

Looking at the question of mortgages and affordability from a little different perspective, at page 11 of our statement there is a detailed discussion of the amount of household income required to qualify for a conforming mortgage today. A 30-year conventional fixed-rate mortgage for $108,000 at a 12-percent interest rate requires a family income under the Fannie Mae underwriting guidelines of $52,929. But Chase Econometric's data indicates that 91.7 percent of all American households have gross incomes of $52,000 or less.

In addition, some of the assumptions in Fannie Mae's calculations are a bit conservative with respect to taxes and insurance, and mortgage interest rates are still generally above 12 percent. So we suspect that a family income of closer to $55,000 or $60,000 a year is today necessary to carry a conforming mortgage loan. Thus, less than 8 percent of all families can qualify for a jumbo mortgage today.

The long and the short of this situation is that neither GE Credit nor any other private sector competitor can successfully compete with Fannie Mae, Freddie Mac, and Ginnie Mae in the market for mortgages of $108,300 or less and that this market already includes 92 percent of all mortgages being originated.

Let me emphasize at this point that GE Credit did not set out to limit our potential market to 8 percent of all mortgages, but that is effectively what has happened because that is all that the private sector has left today.

Based upon the detailed analysis set out at pages 8 through 10 of our prepared statement, $35.3 billion in conventional mortgage-backed securities were issued and sold to investors last year by Fannie Mae, Freddie Mac, and Ginnie Mae combined. Since there were negligible public sales of mortgage-backed securities by private issuers last year, that constitutes the 1982 market demand for mortgage-backed securities, and the three agencies shared virtually 100 percent of it.

MODIFICATION OF MAXIMUM LOAN LIMITS

We understand that Fannie Mae has suggested two approaches to modification of its present maximum loan limits: First, to increase the limitations or remove them entirely; second, to retain the present limits but permit Fannie Mae to invest a percentage basket of its funds in jumbo mortgages above $108,300.

Neither of these approaches will permit Fannie Mae to service the high-cost housing areas without simultaneously excluding the private sector from the great bulk of the remaining 8 percent of the mortgage-backed securities market.

Based again upon Fannie Mae's underwriting guidelines, only 6 percent of American households can presently qualify for a mortgage of $115,000 at 12 percent, and only 4 percent of all families can qualify for a mortgage of $125,000. A $6,700 limit increase would thus eliminate 28 percent of the eligible purchasers, and an increase to $125,000 would eliminate more than half, 52 percent.

Nor does the basket approach work. At this point let me digress just a moment and say it doesn't really make any difference whose assumptions we use with respect to what the size of the market for jumbo mortgages is.

For the sake of dealing adequately with this question, let me take the figures Mr. Kudlow used this morning, an estimated 20 percent of total dollar volume, which is higher than our 8-percent estimate, and the estimates by the Federal Home Loan Bank Board and Freddie Mac that this year there will be $160 billion in total mortgage originations; 20 percent of $160 billion is $32 billion. Of the conventional mortgages originated last year, only half of all mortgages originated went into the secondary market. Of the half that went into the secondary market, only a portion went into mortgage-backed securities. Breaking these numbers down, then, it appears to us that the total potential secondary market for jumbo mortgages for 1983, both those purchased for portfolio and those that are securitized, will be $16 billion.

Looking at Fannie Mae's basket proposal, of the 20-percent basket, based upon their mortgage activity over the prior year, their definition would include both mortgages purchased by Fannie Mae and those that were placed in mortgage-backed securities. That aggregate number is $29.1 billion; 20 percent is $5.8 billion.

For Freddie Mac, the comparable figure is $49 billion purchased and mortgage-backed securities issued; 20 percent of that number is $9.8 billion.

Combine them and we have almost $16 billion in potential purchases by Fannie Mae and Freddie Mac under the 20-percent basket approach. We think that is substantially more than the whole market.

For that reason and a number of other reasons, we think the basket approach is simply not a practical one. It produces real hardships for the first year, and if the total of mortgages serviced goes up as a result of the expanded limits, it guarantees that in future years Fannie Mae and Freddie Mac will be able to occupy the entire market.

I want to dwell just very briefly in passing on one or two of the other requested authority extensions that Fannie Mae has asked for.

One with respect to commercial real estate is dealt with in our statement and is so clearly unrelated to housing purposes as not to require further comment at this point. We strongly oppose that proposed extension.

GE Credit also opposes any extension of Fannie Mae's securities guarantee powers to the pools of mortgages owned by others as effectively completing Fannie Mae's stranglehold over the secondary mortgage market, to the manifest detriment of the private sector.

The necessary effect of raising the maximum mortgage limits will be to refocus Fannie Mae and all mortgage originators, including banks and savings and loans, making conforming loans to target their efforts in the future to the largest mortgages and the most wealthy home owners, at the expense of low- and moderate-income housing.

This suggests that raising or eliminating the mortgage limits will provide subsidized mortgage rates to the most wealthy 8 percent of American households, while making the origination and servicing of moderate-sized mortgages increasingly less attractive. Leaving aside the question of whether this change would be consistent with Fannie Mae's mission, we can discern no necessity or congressional intent to provide a Federal subsidy to wealthy homeowners.

If the operations of the secondary mortgage market are to "be financed by private capital to the maximum extent feasible," and Fannie Mae is to continue to "provide supplementary assistance to the secondary market," as called for in section 301 of the Charter Act, a role must be preserved for the private sector.

Fannie Mae's outstanding new management has already returned it to profitability and repositioned the association's portfolio and activities to avoid the debacles of the past. Fannie Mae is not now in extremis. It does not need an expansion of its activities under its special Federal agency status to remain viable.

There could be no reasonable objection to Fannie Mae or Freddie Mac being permitted to enter new areas of activity in competition with the private sector, provided that their umbilical to the Treasury and other special advantages were eliminated with respect to such newly authorized activities. But once Fannie Mae or Freddie Mac is permitted into a new area under its special agency status, the private sector preclusion is both inevitable and permanent.

We very much appreciate this opportunity to present GE Credit's concerns to the subcommittee.

[The complete statement and response to additional questions follow:]

STATEMENT
OF

DENNIS D. DAMMERMAN
VICE PRESIDENT & GENERAL MANAGER
REAL ESTATE FINANCIAL SERVICES
GENERAL ELECTRIC CREDIT CORPORATION

Mr. Chairman and members of the Subcommittee, it is my pleasure to describe for you today the private sector's role in developing a broad-based and competitive secondary market for residential mortgages and General Electric Credit Corporation's activities in support of that effort.

I am Dennis D. Dammerman, Vice President and General Manager of the Real Estate Financial Services Division of GECC. Since the distinguished panel of witnesses that appeared before this Subcommittee on March 10 has already provided a detailed description of the secondary mortgage market, I will focus primarily upon the efforts of my company to compete in that market and the threat that certain legislative changes currently being actively sought by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) would exclude GECC and any other private sector competitor from participation in that marketplace.

GECC's Role In Financing Housing

Although many people still think of GECC first as a source of financing for consumer appliances, since that is where we started 51 years ago, supporting the sale of GE's monitor-top refrigerator, today nearly one-third of GECC's net receivables are related to housing activities. At year-end 1982, GECC's manufactured housing portfolio was $1.7 billion, our commercial real estate receivables were $790 million, residential first mortgages aggregated $100 million, and second mortgages totalled $760 million. In addition to this $3.5 billion investment, GECC also services a portfolio of $2.4 billion in mortgages and manufactured housing loans owned by investors.

In 1982, manufactured housing units comprised 28% of all housing units constructed, and approximately one out of every six manufactured housing units leaving the factory was purchased through GECC's inventory financing programs. GECC has been a major participant in both the FHA and VA insured manufactured housing programs since their inception and continues to support construction of residential real estate through its commercial lending activities. In 1982, we rolled out our new "Builder Forward" program that provides builders a 12-month commitment on interest rates through the use of sophisticated financial hedging strategies. As a major diversified financial company with more than $12 billion in assets and a triple-A credit rating, GECC has both the financial resources and the expertise to play a significant role in the evolving secondary mortgage market.

During the past three years, it has become apparent that traditional sources of housing investment are providing a decreasing share of the necessary funds. Rampant inflation and broad deregulation of financial institutions have made direct investment in conventional fixed-rate mortgages unattractive at best for depository institutions. Without a secondary market for residential mortgages, many banks and savings and loans, as well as mortgage bankers, would have had very limited funds available to originate new mortgages.

Recognizing this new need, we have been positioning GECC to take an active part in the development of a private sector secondary mortgage market, commencing with the organization of a private mortgage insurance company in 1980, the acquisition of a mortgage banking subsidiary in 1981, the filing with the Securities and Exchange Commission of a shelf registration for $300 million in mortgage-backed securities in 1982, and the acquisition of American Mortgage Insurance Company, completed less than two months ago.

Although creation of GECC's necessary backroom facilities is not yet complete enough for a full roll-out of our new mortgage-backed securities program, GECC, through one of its subsidiaries, has already successfully test-marketed its mortgage pass-through securities in a private placement to the Teacher Retirement System of Texas teachers' pension fund of $64 million in mortgage-backed securities, rated "AAA" by Standard & Poors. In addition, through insurance written by another of its subsidiaries, GECC assisted the Michigan State Housing Development Authority in issuing $80 million in AAA-rated bonds at a substantial saving in interest cost to the authority, by permitting the yield to investors to be reduced by one-half percent (50 basis points).

While we have been preparing to enter this market, however, Fannie Mae rolled out its own mortgage-backed securities program in October 1981, issuing $717 million of such securities in 1981 and $14.0 billion in 1982. Fannie Mae created these securities by packaging conventional residential mortgage loans conforming with its statutory requirements, including the limitation as to maximum size, which is currently indexed at $108,300. Freddie Mac, whose sale of "Participation Certificates" dates back to 1971, also made an aggressive entry into the mortgage-backed securities market in 1981, issuing some $5.2 billion in certificates, and has issued $25.3 billion in its "Guarantor" program in 1982.

Fannie Mae's and Freddie Mac's Statutory Advantages

Fannie Mae and Freddie Mac enjoy two commanding advantages over their private competitors that eliminate any possibility for meaningful competition in the mortgage-backed securities market with respect to loans conforming to Charter Act requirements. The first of these advantages is Fannie Mae's and Freddie Mac's relationship with the United States Treasury, which enables them to sell their securities at a yield which, while slightly higher than that commanded by Ginnie Mae's, is significantly below that obtainable on the most highly rated private issues (e.g., Standard & Poors "AAA"). The second advantage is Fannie Mae's and Freddie Mac's exemption from S.E.C. securities registration requirements, which reduces their costs in packaging mortgage securities significantly below the levels achievable by private competitors.

Moreover, there is a third advantage in marketing the resulting mortgage-backed securities, since federal law elevates Freddie Mac's securities to the status of "obligations issued by the United States" for purposes of qualifying with state fiduciary investment statutes [Federal Home Loan Mortgage Corporation Act, 12 U.S.C. §1455(e)(1)], and Fannie Mae is seeking the same status for its securities.

Shifting GECC's Focus to the Remaining Market

In response to Fannie Mae's entry into the mortgage-backed securities market and in light of Fannie Mae's and Freddie Mac's overwhelming governmentally-conferred competitive advantages, GECC has shifted its focus to packaging so-called "jumbo" loans, those larger than the current federal limit of $108,300. These loans represent the remaining market open to the private sector, and, according to a Federal Home Loan Bank Board survey of 2,000 mortgage originators conducted from June 1982 through February 1983, conventional residential mortgages in excess of $108,300 represent only between 5.9 and 7.9 percent of all conventional mortgages originated, as the following table indicates:

TABLE I

FHLBB SURVEY
MORTGAGE LOANS ORIGINATED
PERCENTAGE ABOVE AND BELOW $108,300

		Loans Less Than $108,301	Loans Over $108,300
1982	June	94.1%	5.9%
	July	92.8	7.2
	August	93.4	6.6
	September	92.6	7.4
	October	92.1	7.9
	November	92.2	7.8
	December	93.6	6.4
1983	January	93.5	6.5
	February	92.2	7.8

It is GECC's understanding that Fannie Mae and Freddie Mac have now requested that the Subcommittee repeal all limitations on the size of the mortgages they may purchase and package into mortgage-backed securities, and Fannie Mae has also requested the additional expansion of its powers into non-residential commercial real estate activities. The elimination of lending limits for Fannie Mae and Freddie Mac will effectively exclude private competitors from the mortgage-backed securities packaging business and preclude private sector involvement in the development of a secondary mortgage securities market.

The Commanding Advantages of Cost Savings Due To Agency Status

Let me first demonstrate to you why no private sector company can successfully compete in the capital markets with securities issues that are treated by investors as tantamount to federal issues, and then turn to a discussion of the size of the secondary market for mortgages in excess of $108,300 and the exclusion of the private sector market that would result from the proposed changes to that limit.

During 1982, Fannie Mae's new debt obligations were sold at yields between 35 and 90 basis points (.35 to .90 percentage points) higher than comparable Treasury securities, closing 1982 at about a 30-45 basis point spread. GECC's comparable cost of borrowing on our triple-A rated debt obligations approximates 50 basis points higher than Fannie Mae's borrowing costs, or about 85 to 90 basis points above comparable Treasuries. This translates to a one half of one percent cost differential in favor of Fannie Mae in what it must pay for funds on the open market, and this lower cost is due entirely to Fannie Mae's special Charter Act status.

A well run mortgage-backed securities program should incur only limited debt carrying costs, for a period of perhaps 45 to 90 days, to hold the purchased mortgages briefly pending completion of the pool and sale of the resulting certificates to the ultimate investors. But Fannie Mae's cost advantages carry through to the yields Fannie Mae must pay in marketing its mortgage-backed securities, and those yields translate directly to the price Fannie Mae can afford to pay the mortgage originators from which it purchases mortgages.

This point can best be illustrated by looking at the April 15, 1983 yields on Fannie Mae's 12% conventional 30-year mortgage-backed securities at 11.95 percent and Bank of America's 12% conventional 30-year mortgage pass-throughs (rated "AAA"), yielding 12.40%, for a spread of 45 basis points. (This spread may actually be understated due to current market conditions, since the spread two weeks earlier was 65 basis points and four weeks earlier was 91 basis points.) In order to reduce this spread and remain competitive in the market place, a private sector issuer must either develop methods to lower its packaging costs or reduce the yield it pays to the mortgage originator on mortgages purchased for pooling.

Similarly, the S.E.C. registration requirements add a cost increment of about 40 basis points on a $50 million issue of mortgage-backed securities, although the learning curve effects on the first registration are likely to produce substantial one-time costs for new market entrants, as well as delaying bringing subsequent new issues to market. While the basis point cost on the larger issues GECC contemplates making will be less, this remains as an additional cost to the private sector.

Moreover, at least with respect to Freddie Mac, with its statutory preemption of state fiduciary investment laws, there is a significant potential market of investors that can presently purchase mortgage-backed securities from Freddie Mac but not from private sector competitors. As an example of the types of such investors interested in purchasing mortgage-backed securities, a Department of Housing and Urban Affairs study estimates that private, non-insured pension funds hold, as "nominees", about 17 percent of the $110 billion in Ginnie Mae certificates outstanding, and public and private pension funds hold another 8.8 percent in their own names.

Since mortgage originators shop aggressively to obtain the highest possible yields available when selling their mortgages in the secondary market, any incremental costs that private sector competitors must pay necessarily reduces private issuers' ability to compete successfully in this market with federally subsidized agencies. Between the higher yields that private issuers of mortgage-backed securities must pay to investors and the additional costs enumerated above, the private sector has effectively been precluded from operating in the secondary market for mortgage loans of $108,300 or less.

Parameters of the Secondary Market

One of the hardest tasks in analyzing the size of the secondary mortgage market and future demand for secondary market investment is that there are so many uncontrolled variables. After the experiences of the last four years, few economists are willing to make long-range interest rate forecasts and even fewer financial managers are willing to stake their businesses on those projections.

There will always be some portion of all mortgage originators whose cost structure or deposit base will permit them to maintain direct investment in all or part of the mortgages they originate. With the proliferation of alternative mortgage instruments containing a variety of characteristics that provide a better match with liabilities, such as rapid amortizing ("growing equity") mortgages, as well as variable rate and re-negotiable rate mortgages that are indexed to money cost, there is an additional group of mortgages that may or may not be offered in the secondary market by their originators. There are also private seller-financed residential mortgages that may remain outside of the traditional mortgage originator channels entirely.

Since interest rates and money costs so heavily influence the level of demand for the secondary market at any given point in time, projection of finite market size is extraordinarily difficult. But over the past four years, conventional mortgages have been 79 to 80% of the dollar volume of all mortgages originated and less than half of all conventional mortgages in dollar volume have been sold in the secondary market by their originators; i. e., 1979 = 26%, 1980 = 34%, 1981 = 41%, 1982 = 49%. Total sales of newly originated conventional mortgages into the secondary market in 1982 were $37.1 billion. (Department of Housing & Urban Development, Survey of Mortgage Lending Activity.)

Turning to an analysis of those conventional mortgages placed into mortgage-backed securities last year, Fannie Mae, Freddie Mac and Ginnie Mae together actually issued $55.3 billion in mortgage-backed certificates -- Fannie Mae issued $14.0 billion, Freddie Mac issued $25.3 billion in its "Guarantor" program, and Ginnie Mae issued $16.0 billion. A significant amount of these certificates represented swaps with bank and thrift institution mortgage originators, however, for existing mortgages held in portfolio, not all of which were offered for resale to non-traditional housing investors. The respective swap figures for each agency were: Fannie Mae, $10.8 billion; Freddie Mac, approximately $14.3 billion; and Ginnie Mae, $4.9 billion. Although Salomon Brothers estimates that one-third of this $30.0 billion in swaps was resold, the other $20.0 billion was retained in portfolio. Thus, of the $55.3 billion in certificates issued, only some $35.3 billion were, ultimately, purchased for investment and can be considered to be the 1982 market demand for mortgage-backed securities.

Based upon Freddie Mac's June 1982 analysis of the sales of mortgage-backed securities since 1971, of the aggregate $161.024 billion in pass-through securities issued, private issuers other than Fannie Mae, Freddie Mac, and Ginnie Mae accounted for only one percent ($1.61 billion), and the private issues were all made in the period from 1977 through August 1980. If private placements are included, total private sector issuance of mortgage-backed securities to date total only some $4.0 billion, according to a March 1983 analysis by Salomon Brothers, Inc. It can fairly be asserted, then, that Fannie Mae, Freddie Mac, and Ginnie Mae have a near total monopoly on the mortgage-backed securities market today, even under their 1982 statutory mortgage limits of $107,000, and that the Fannie Mae and Freddie Mac proposals must be considered against this background.

As I discussed earlier, a Federal Home Loan Bank Board survey of 2,000 mortgage originators in the second half of 1982 indicates that less than 8 percent of all conventional mortgages actually originated exceeded $108,300 (see Table I) and Freddie Mac has indicated that in 1982 only 10 to 12 percent of all homes sold had mortgage loan amounts above $107,000. (Statement of Kenneth J. Thygerson at 8, March 10, 1983.) According to the Office of Management and Budget's analysis, jumbo mortgages represent about 20 percent of the total dollar demand for conventional mortgages, which themselves have typically represented 80 percent in dollar volume of all mortgages originated (FHA and VA-insured mortgages make up the balance). Thus, jumbo mortgages are estimated to be about 16% of the total dollar volume of all mortgages originated (20 percent of 80 percent is 16 percent) and 49 percent of conventional mortgage volume was sold in the secondary market in 1982, so sales of jumbo mortgages into the secondary market were approximately 8 percent of total dollar volume (16 percent times 49 percent is 8 percent).

Looking at Fannie Mae's own mortgage underwriting guidelines, an annual household income of $52,929 is required to qualify for a 30-year conventional fixed-rate mortgage of $108,000 at a 12 percent interest rate. Based upon Chase Econometrics' Resource Data Associates (RDA) survey of 1981 gross household income from all sources (the latest data available), 91.7 percent of American households fall below the $52,000 income level. Since mortgage interest rates are still generally above 12 percent and Fannie Mae's assumption of annual real estate taxes and insurance costs at only 1 percent of market value is very conservative, we suspect that a family income of closer to $55,000-$60,000 is required to carry a conforming loan of $108,300. Table II shows the buyer's income required to qualify for mortgages of $108,000 and above:

Table II

FNMA UNDERWRITING GUIDELINES BUYER QUALIFICATION TABLE

Selling Price	Mortgage Amount	Yearly P & I	Yearly Tax & Ins	Total Year PITI	Gross Annual Income
$144,000	$108,000	$13,380	$1,440	$14,820	$ 52,929
153,000	115,000	14,195	1,530	14,725	56,161
167,000	125,000	15,429	1,670	17,099	61,068
200,000	150,000	18,515	2,000	18,715	66,839
233,000	175,000	21,601	2,330	23,731	85,468
267,000	200,000	24,687	2,670	27,357	97,703
333,000	250,000	30,858	3,330	34,188	122,100
400,000	300,000	37,030	4,000	41,030	146,536
467,000	350,000	43,202	4,670	47,872	170,971
533,000	400,000	49,373	5,330	54,703	195,368

Assumptions

12% interest rate
Fixed-rate 30-year mortgage
Average loan-to-value ratio (LTV) of 75%
Annual taxes and insurance = 1% of selling price

Thus, the potential secondary market demand for mortgages above $108,300 appears to be less than 8 percent in dollar amount of all mortgages originated, and fewer than 8 percent of all American households can qualify for these jumbo mortgages. GECC and other private sector companies, such as Banco Mortgage Company's Residential Funding Corporation, are thus effectively limited to competing for 8 percent of the total mortgage dollar volume today, while Fannie Mae, Freddie Mac, and Ginnie Mae are already authorized to service 92 percent of all conventional mortgages originated and, in fact, obtained virtually 100 percent of the total potential mortgage-backed securities market in 1982 under their present limitations.

Effect of Increases in Mortgage Limitations on Market Exclusion

Fannie Mae has suggested two approaches to modification of its present maximum loan limits: (1) increase the limitations or remove them entirely, and (2) retain the present limits, but permit Fannie Mae to invest a percentage "basket" of its funds in jumbo mortgages above $108,300. Neither of these approaches will permit Fannie Mae to service the high cost housing areas without simultaneously excluding the private sector from the great bulk of the remaining small market for issuance of mortgage-backed securities.

Looking at the data on gross household income and the Fannie Mae loan underwriting guidelines, only 6 percent of American households can qualify for a 30-year, 12 percent conventional mortgage of $115,000, and only 4 percent of all households can qualify for a 30-year mortgage of $125,000 at 12 percent interest. Raising the present statutory limit by only $6,700 to $115,000 would, thus, eliminate 28% of the remaining market, while raising the limit to $125,000 would eliminate more than half (52%) of the remaining market. Moreover, in the highest cost housing markets in the country, such as Orange County, California; the San Diego area, the Dallas area, metropolitan Washington, D.C.; Fairfield County, Connecticut; and the New York and New Jersey suburbs of New York City, mortgage limits of $150,000 or more would be necessary if Fannie Mae were to serve those markets. At that level, there would effectively be no potential market left at all for the private sector.

Nor does Fannie Mae's proposed 20 percent basket approach work. In 1982 Fannie Mae purchased $15.1 billion in mortgages and issued $14.0

billion in mortgage-backed securities, for a total dollar amount of $29.1 billion of "mortgages purchased by the corporation, loans made on the security of such mortgages and such mortgages pooled in securities guaranteed by the corporation.". Twenty percent of that amount is $5.8 billion. But by the analysis set forth previously, the total market for conventional mortgage-backed securities in 1982 was $35.3 billion, and, according to our analysis that 16 percent of total dollar demand is for mortgages above $108,300, the total market for non-conforming conventional mortgage-backed securities would appear to be smaller than Fannie Mae's new "limit" ($35.3 billion times 16 percent equals $5.6 billion). With a 10 percent basket, Fannie Mae's limit would still be $2.9 billion, or 52 percent of the jumbo mortgage-backed securities market, and Freddie Mac's request for parity on any limitation increase precludes any possibility that even a tiny share of the market would be left for the private sector.

Unless Fannie Mae and Freddie Mac are prevented from using their federal subsidies in competing for jumbo mortgages in the secondary market, any increase in their loan limitations will de facto limit or preclude entirely the participation of the private sector in this market. Nor is the size of the top-end conventional mortgage-backed securities market of any practical impact -- $5.6 billion or $12.8 billion,*/ Fannie Mae and Freddie Mac will effectively out-bid unsubsidized private sector competitors.

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*/ Estimated 1983 mortgage originations of $160 billion times 16 percent (jumbo conventional mortgage market share) times 50 percent (less than half of all conventional mortgages were sold in the secondary market in 1982) equals $12.8 billion.

Effects of Authorization of Nonresidential Commercial Real Estate Activities on Fannie Mae's Mission

Fannie Mae has also requested authority to invest in nonresidential commercial real estate for the first time; up to a 10 percent basket of the prior year's total mortgage activities. Based upon the analysis above, that would translate to $2.9 billion during the first year for investment in shopping centers, office buildings, industrial plants, and other commercial facilities that do not add to the nation's housing stock.

Not only would such activities divert resources from Fannie Mae's traditional role of supporting low and moderate-priced housing, they are patently inconsistent with the statutory objectives of the Charter Act. There is no shortage today of private capital available for development of nonresidential commercial real estate, and no justification exists for creating a governmentally-subsidized program under the aegis of Fannie Mae.

Additional Fannie Mae Securities Guarantee Powers Would Further Exacerbate Private Sector Exclusion

Having already effectively preempted private sector participation in mortgage-backed securities programs by its proposals on limitation increases, Fannie Mae's proposal that it be authorized to guarantee pools of mortgages owned by others would complete Fannie Mae's stranglehold on the secondary mortgage market.

Based upon our previous analysis, Fannie Mae, Freddie Mac, and Ginnie Mae in 1982 together shared virtually 100 percent of the mortgage-backed securities market. By permitting third party owners of mortgage pools to obtain the federal eagle evidencing Fannie Mae's insurance on their securities, that much larger share of the mortgage-backed securities market would be occupied by certificates exempt from S.E.C. and state fiduciary investment laws, to the manifest detriment of private sector competitors.

Moreover, these additional activities would increase Fannie Mae's investment base, which would further exacerbate the market exclusion potential of their proposed basket exemptions on mortgage limitations that we discussed earlier.

Crowding Out Effect of Expanded Fannie Mae/Freddie Mac Borrowings

Fannie Mae is already the sixth largest company in the United States in size of assets. According to its 1982 Annual Report, Fannie Mae is "usually the second largest borrower in the capital markets behind the U.S. Government," and already owns one out of every twenty mortgages on American homes. (Id. at 3)

In 1982, when U. S. mortgage originations totalled $94.9 billion, Fannie Mae's mortgage purchases and issuance of mortgage-backed securities totalled $29.1 billion. Freddie Mac's aggregate purchases of mortgages and issuance of mortgage-backed securities totalled 49.0 billion. Accepting Fannie Mae's estimate of annual average mortgage originations of $230 billion for each of the next seven years and Freddie Mac's estimate of $160 billion of new mortgages originated in 1983, it is conservative to assume that Fannie Mae's and Freddie Mac's borrowing needs and issuance of mortgage-backed securities will exceed $100 billion per year over that time frame if they maintain or expand their market shares.

Since these borrowings and sales of securities compete with Treasury obligations and Ginnie Mae's in the public debt market, they will inexorably increase the yield demanded by investors on all government debt and securities issues, while crowding out private borrowers from the capital markets. To the extent that borrowing costs are driven up, any asserted cost savings to consumers from Fannie Mae's and Freddie Mac's federal subsidies become illusory, of course, negating any possible advantage from their proposed preemption of private sector competition in mortgage-backed securities.

Certain of Fannie Mae's Present Activities are Inconsistent With Statutory Mission; Broadened Powers Will Only Detract Further From Proper Role

Starting in late 1981, Fannie Mae moved aggressively into the purchase of second mortgages, buying $1.6 billion in 1982 for its own portfolio at net yields (after deducting servicing) only 1/4% higher than on first mortgages. While this activity has reduced the spread between first and second mortgages from the 200 to 300 basis points historically charged in the competitive private marketplace to 100 to 200 basis points, it has greatly distorted a vigorous, competitive private sector market by tapping Fannie Mae's special access to the capital markets and has virtually assured that Fannie Mae, and not the private sector, will provide the future secondary market for second mortgages. In 1982, for example, it is estimated that Fannie Mae's volume in the secondary market for second mortgages was three times as great as that in the private secondary market.

Since Fannie Mae has stated publicly its intention to purchase between $3.5 and $5.0 billion in second mortgages in 1983, its direction is clear. Under its present program, Fannie Mae purchases second mortgages of up to $108,300, where it does not already own the first mortgage -- and mortgages placed in pools for issuance of mortgage-backed securities are treated as not being owned by Fannie Mae. (FNMA Second Mortgage Plan at 3.) There is no requirement that the second mortgage be for housing-related purposes, and no effective incentives to encourage home improvement or energy conservation expenditures. In short, Fannie Mae is applying the privileges of its federal charter to expand its business beyond housing purposes.

Similarly, raising the maximum mortgage limits would refocus Fannie Mae and all mortgage originators presently making conforming loans to target their efforts to the largest mortgages and the wealthiest homeowners, at the expense of low and moderate income housing. Since the servicing fees earned by mortgage originators are directly proportional to the size of the mortgage, one $200,000 mortgage earns the same fee as four $50,000 mortgages, with one fourth as many accounts to handle and at one fourth or less in administrative costs. Moreover, the risk of default on the smaller mortgages may be greater, since the homeowner is likely to be more dependent upon income from current employment to service his mortgage debt and is likely to have fewer liquid assets to draw upon to avoid default in periods of unemployment.

This suggests that the net effect of raising or eliminating mortgage limits will be to provide subsidized mortgage rates to the most wealthy eight percent of American households, while making the origination and servicing of moderate-sized mortgages increasingly less attractive. Leaving aside the question whether this change would be consistent with Fannie Mae's mission, we can discern no necessity or Congressional intent to provide a federal subsidy to wealthy homeowners.

If the operations of the secondary mortgage market are to "be financed by private capital to the maximum extent feasible," and Fannie Mae is to continue to "provide supplementary assistance to the secondary market," as called for in section 301 of the Charter Act, a role must be preserved for the private sector. Fannie Mae's management has already returned it to profitability and repositioned the association to avoid the debacles of the past -- Fannie Mae is not now *in extremis* and does not need an expansion of its activities under its special federal agency status to remain viable.

There could be no reasonable objection to Fannie Mae being permitted to enter new areas of activity in competition with the private sector, provided that its umbilical to the Treasury and other special advantages were eliminated with respect to such newly authorized activities. But once Fannie Mae is permitted to enter a new area under its special agency status, the private sector preclusion is both inevitable and permanent.

Conclusion

GECC concurs in the absolute necessity for more private sector competitors in the secondary mortgage markets that was identified in David Maxwell's March 10 testimony on behalf of Fannie Mae. As he noted:

> "Congress acted very prudently by creating Fannie Mae, FHLMC and GNMA, but they cannot be expected to do the whole job. The private sector must be given greater incentives to develop its own secondary market institutions. Providing for the entry of these more private competitors is not easy, but it must be done." (Id. at 13.)

Freddie Mac's testimony echoed these sentiments:

> "The Role of Secondary Markets
>
> The housing finance system will increasingly rely on the secondary mortgage market for the delivery of home mortgage credit. To understand fully how and why this will happen, it is useful to look more closely at the role of secondary markets in the delivery of mortgage credit. In so doing, an important point will become clear. The key to the ability of secondary market institutions to provide tremendous benefit to homebuyers, without Congressional appropriation, is their interaction with, and reliance on, private financial market participants." (Statement of Kenneth J. Thygerson, Tab 1 at 7-8, March 10, 1983.)

Unfortunately, certain amendments that are being sought by Fannie Mae and Freddie Mac will, if enacted, effectively exclude all present and potential private sector competitors from the evolving mortgage-backed securities market, not just temporarily, but permanently.

Although these changes have been described by Fannie Mae as being "a modest extension of our asset powers," their effect is far more sweeping. The requested amendments would represent a significant change in Fannie Mae's focus and detract from its traditional mission in support of low and moderate income housing.

Given Fannie Mae's return to profitability under the outstanding leadership of its present management, the proposed amendments are not needed to achieve sound financial health and would be unnecessarily destructive to emerging private sector participation and competition in the secondary markets. Nor are the proposed changes without cost implications for the public debt market and the private capital markets.

In short, GECC respectfully urges that the requested amendments to the Charter Act be rejected, and that any future expansion of Fannie Mae's and Freddie Mac's business activities be limited to unfettered competition in the marketplace, free of ties to the Treasury or other special treatment.

General Electric Credit Corporation

Dennis D. Dammerman

Vice President and General Manager
Real Estate Financial Services

260 Long Ridge Road
Stamford, Connecticut 06902
(203) 357-4540

August 3, 1983

Honorable John Tower
Subcommittee on Housing & Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

I am enclosing General Electric Credit Corporation's response to the additional questions you raised following our May 5, 1983 testimony on the secondary mortgage market.

We appreciate your courtesy in inviting us to testify and the careful consideration you and your staff are giving to the important public policy issues involved in preserving a role for private sector competitors in meeting national housing needs.

We will be happy to expand upon these answers or deal with any other questions you may have.

Sincerely,

DDD:an
Enclosures

cc: J. French Hill
Peter B. Harkins

Question 1

What percent of the mortgages you purchase are below the current mortgage limit of $108,000? Why do you feel that you cannot compete in this sector of the market to a greater extent?

Answer

G.E. Credit deals in conventional mortgages in two capacities: (1) General Electric Mortgage Corporation, our mortgage banking subsidiary, headquartered in Portland, Oregon, originates conventional mortgages, primarily under the $108,300 mortgage limit, most of which are sold in the secondary market to FNMA and investors not related to GECC; and (2) General Electric Mortgage Capital Corporation, our mortgage-backed securities conduit, headquartered in Raleigh, N.C., which is organized to purchase conventional mortgages for packaging into pools for the issuance of mortgage-backed securities. It is anticipated that this business will purchase so-called "nonconforming" conventional mortgages, except for a few mortgages under $108,300 that may be included in a larger pool by a mortgage originator selling to us, or which are not eligible for purchase by FNMA for reasons other than the mortgage limit.

As we detailed in our testimony before the Subcommittee on Housing and Urban Affairs on May 5, 1983, G.E. Credit must pay a higher yield to investors than Fannie Mae and Freddie Mac to sell our mortgage-backed securities, we must meet rigorous Securities & Exchange Commission registration requirements from which Fannie Mae and Freddie Mac are exempt, and the resulting economic realities demand that we require a higher yield from each mortgage originator than do Fannie Mae and Freddie Mac. Under such circumstances, no company can compete effectively with these governmentally-chartered agencies in the purchase of conforming mortgage loans from originators.

Question 2

Fannie Mae argues that they need amendments to their Charter Act to "repair their balance sheet over the next several years." Mr. Maxwell points out that they are extremely vulnerable to interest rate swings right now. Would you comment on their argument that they must have these new authorities to remain financially healthy.

Answer

As long as Fannie Mae continues to increase its direct portfolio investment in fixed-rate mortgage loans, without matching this investment with fixed-rate borrowings of comparable maturity, it will always be "vulnerable to interest rate swings." Since January 1, 1982, Fannie Mae has increased its net portfolio from about $60 billion to $74 billion, on a total net worth of about $1.25 billion, apparently anticipating that interest rates will not increase appreciably over the life of the mortgages (approxmately twelve years on the average).

During this same time frame, Freddie Mac has actually decreased its net mortgage portfolio to less than $5 billion, on a net worth of about $.3 billion, while issuing more than $24 billion in Participation Certificates and GMC's in 1982 alone.

Since Fannie Mae has voluntarily assumed this additional interest rate exposure, it seems inappropriate that at the same time it is requesting additional authorities to purportedly bail out Congressionally-mandated activities.

Using this sort of rationale, Fannie Mae could make a case for being permitted to operate in a wide variety of other businesses whether or not related to housing finance, creating a truly awesome potential with which no private company could compete.

The public policy issue is not whether Fannie Mae should be financially healthy: it is whether Fannie Mae and Freddie Mac should be given a statutory duopoly at the expense of excluding private sector competitors from the secondary mortgage market.

Senator **Proxmire**. Thank you very much, Mr. Green.

Our next witness is Mr. Marvin Gilman.

MARVIN GILMAN, CHAIRMAN, MORTGAGE FINANCE COMMITTEE, NATIONAL ASSOCIATION OF HOMEBUILDERS

Mr. **Gilman**. Thank you, Senator Proxmire.

My name is Marvin S. Gilman. I am a homebuilder and developer from Wilmington, Del. I am a past president of the Homebuilders Association of Delaware and a former vice president of the more than 107,000-member National Association of Homebuilders.

I served for 4 years as a Presidentially appointed member of the Board of Directors of Fannie Mae, and I am now chairman of the mortgage finance committee of NAHB.

I am here before you today in the instance of the unavoidable absence of the president of the association, Mr. Harry Pryde, who is out of town and asks that I extend his regrets.

In the interest of time, I will not read his full statement, but ask that it be entered into the record.

I would like to take the opportunity to summarize NAHB's views on the proposed amendments to the Charter Acts of Fannie Mae and Freddie Mac, as well as participation of the private entities in the secondary mortgage market.

It is evident, I think, to all of us that the evolution, particularly over the last 10 years of residential mortgage financing as well as the process of deregulation of the thrift institutions, combined with major cyclical swings in interest rates, have made the secondary mortgage market the cornerstone of the entire residential financing industry.

This secondary market, principally through Fannie Mae, Ginnie Mae, and Freddie Mac, has opened capital markets for housing. In 1982, well over one-half of all mortgages originated wound up in the secondary market.

GOVERNMENT AGENCIES MONOPOLIZE SECONDARY MORTGAGES

At the present time, Fannie Mae owns, as has been pointed out, some $73 billion worth of mortgages, approximately one out of every 20 mortgages outstanding, and the reason for that is that since its inception and since its privatization in 1968, whether under the leadership of Ray Lapin, Oakley Hunter, or its present Chairman David Maxwell, Fannie Mae has stayed in the mortgage market good years and bad.

Last year, the worst year in the housing finance market in my memory, Fannie Mae bought almost 15 percent of all mortgages originated. In addition, Fannie Mae has been a creative force in the mortgage market, particularly for modest income housing.

Fannie Mae's experience with the low downpayment FHA and VA loans led it to pioneering the 5-percent downpayment conventional loan, not to mention the buydowns and growing equity mortgages which meant so much in 1982 to keeping the building industry viable.

Both Fannie Mae and Freddie Mac have been leaders in dealing with the National Association of Homebuilders, Home Mortgage

Access Corp., a conduit for the smaller builder, to enable that builder to compete.

Our view is that there is plenty of room for all, but private programs must prove that they can successfully meet the challenge. We have seen that in years of difficulty the strictly private lenders——

Senator PROXMIRE. Mr. Gilman, I just want to interrupt for a minute to announce that the chairman has come back. I will have to leave, unfortunately, but it has been excellent testimony.

Our highly competent chairman has just been leading cheers for Pennsylvania on the steps of the Capitol.

Senator HEINZ. I want to thank my member for chairing these hearings.

Mr. Gilman, please continue.

Mr. GILMAN. It's nice to have you here, Senator Heinz.

The primary issue is of mortgage-backed securities. The private instrumentalities in the past few years were out of the market from 1980 well into 1982, when times got tough, they couldn't stay with it, but they too are needed, though they simply don't cover the whole range of the market. We hope with experience, though, they will learn just the way FNMA and FHLMC have learned. All are needed. We welcome the entry of all elements into the market.

The one thing we want to be sure, however, is that with the entry of new elements, until these elements are completely tested through the fire of housing and interest rate cycles that we don't weaken the institutions which have kept alive and well the housing industry and made it possible for homeownership to continue during difficult periods.

As to the mortgage limits, quite frankly, I believe that a ceiling of $108,300 on a national basis for a single-family home is unrealistic. The average price of a house in some 18 SSMA's is more than that. This limit on a national basis simply penalizes those home buyers who happen to be in areas where the average-priced house is elevated.

The present mortgage limits create a monopoly not for FNMA and FHLMC, but quite to the contrary, they create a monopoly for those private institutions who are willing to get into the market at this particular time. As home builders, we don't believe in monopoly, and we believe in a maximum of competition. We don't blame them for trying to preserve what they have, but last year this same Senate Banking Committee approved the lifting of the limits stating that such actions "would enable the secondary market to more fully support primary lenders."

I think the only fault that anybody can find with that statement is that it splits an infinitive. It's hard for me sitting here today to try to ascertain the size of the market we're talking about. Hopefully, if we finish this hearing before dark there will be some market left, but it appears to be disappearing rapidly.

Senator HEINZ. Don't be too sure.

Mr. GILMAN. Mr. Kudlow said it was 20 percent, Ms. Hallbauer said it's 12 percent. Mr. Green says it's 8 percent. It's going fast. [Laughter.]

It reminds me, really, of the lady at the summer resort hotel who, after dinner, said, "This food is poison, and such small portions." [Laughter.]

Whether it's 20 percent or whether it's 8 percent, it's a significant portion of the American home buying public. And just because a member of that home buying public happens to be unfortunate enough to be in California rather than in Wilmington, Del., or Pittsburgh, Pa., is no reason why that home buyer should be penalized. FHLMC and FNMA have proven that they will stay with buyers of modest-priced housing in bad times as well as good. Home buyers who live in areas of high costs should have the same protection. There is plenty of room for everybody, and FNMA and FHLMC have been fair competitors. They have never used their agency status to drive off the competition.

We cannot afford a congressionally sanctioned monopoly. We believe that the limits should be lifted completely. If this is not in line with the committee's view, we think that no less than a 150-percent allowable increase is warranted. The National Association of Home Builders supports FNMA's very limited request for participation in nonresidential mortgages, provided that such mortgages are related to neighborhoods and subdivisions.

We also support continuation of the power of these organizations to buy in second mortgages, but we believe that their second mortgage activity should be restricted to housing and closely related real estate. Second mortgages should be limited to purchase money mortgages, home improvement loans and energy conservation loans. If they are not thus limited, it seems to me that they should be limited to $50,000 on a single-family home and $60,000 on a two- to four-unit dwelling. The limit should not be extended to combine first and second loans. We believe that until we have more experience with this matter, the sunset provision should be continued on second mortgage powers, so that Congress can examine such a sunset on October 1, 1985. This, it seems to me, is perfectly reasonable.

We support FNMA's request for authority to guarantee mortgage-backed securities, so that they don't have to buy the mortgages in order to issue them with their guarantee. We also support their request to liberalize their ability to make loans on the security of mortgages. We also support FNMA's request to lift the loan to value limits on its multifamily housing. We support FNMA's request for a releasing of some of the HUD approval power over FNMA programs, but in its place, we request that the Congress and HUD receive annual reports from FNMA on its previous year's activity, and that these reports when issued become the subject of hearings before the appropriate committees in the Congress.

Senator HEINZ. Mr. Gilman, I want to indicate to our witnesses that we have a 5-minute rule. You're all advised of it, I'm told. I am going to have to religiously and even relentlessly, if you are unable to summarise your statements, they will be summarily summarized at the conclusion of 5 minutes.

I apologize to you for having—in this morning's hearing having gone over. Sometimes it's inevitable, but there are certain time requirements which we have to observe due to the constraints on the floor and elsewhere, so I am going to have to insist that everybody stop at 5 minutes.

So Mr. Gilman, thank you very much.

Mr. Davis, you're next.

[Complete statement follows:]

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)
before the
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
on
THE SECONDARY MORTGAGE MARKET
on
MAY 5, 1983

Mr. Chairman and Members of the Committee:

My name is Harry Pryde and I am a homebuilder and developer from Seattle, Washington. I am testifying on behalf of the more than 107,000 members of the National Association of Home Builders (NAHB), of which I am President. NAHB is a trade association of the nation's homebuilding industry. I am pleased to be able to present NAHB's views on the proposed amendments to the Charter Acts of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) as well as the participation of private entities in the secondary mortgage market. Underlying our position is the principle that the existing secondary market entities should be kept vital and sound so that they can serve the housing market as that market is opened up to new private entities.

The secondary mortgage market has become the cornerstone of the entire residential mortgage finance system in America. FNMA, FHLMC, and the Government National Mortgage Association (GNMA) provide liquidity to primary mortgage lenders. They attract enormous investment from individuals and institutions into housing. The sheer volume of trade done by these three secondary market institutions illustrates their importance to the national system of housing finance. FNMA currently holds $75 billion in mortgages, roughly 1 out of every 20 mortgages. By the end of February 1983, FHLMC had issued $49.5 billion in Participation Certificates in its mortgage-backed securities program. GNMA in turn had guaranteed over $138 billion in mortgage-backed securities by the end of 1982. Last year over one-half of all mortgages originated were sold in the secondary market.

FNMA, GNMA, and FHLMC are extremely important for the counter-cyclical role they play in the housing markets. They cushion the downward swings of the housing industry by sustaining a flow of funds. Last year, during one of the worst years ever for housing, FNMA purchased one of every seven mortgages originated. As a result of these agencies' efforts, mortgage money remained available -- albeit expensive -- throughout the interest rate cycle. Many builders and lenders give credit to these entities for pulling them through the recession.

FNMA and FHLMC created the conventional secondary market and continue to be on the cutting edge with innovative products and techniques. A major need at present is for modest housing for the first time homebuyer. FNMA and FHLMC have served that need by creating markets for 5 percent downpayment conventional mortgages for condominiums. They have been instrumental in bringing new buyers to the market through their willingness to purchase new mortgage instruments such as buydown mortgages and growing equity mortgages. Both entities have been willing to negotiate special transactions for mortgage loans falling outside their normal guidelines. For example, both have agreed to provide mortgage commitments directly to homebuilders through NAHB's Home Mortgage Access Corporation.

The existing secondary market entities will have to be even more vigorous to meet the heavy demand for mortgage money during the 1980s, as the postwar baby boom generation continues to enter the housing market. The demand for mortgage originations during 1983 has been estimated at $150 billion -- not including refinancing. The need for the remainder of the decade has been estimated by FNMA at approximately $1.6 trillion. By 1990 the share of mortgages sold on the secondary market is expected to increase to between two-thirds and three-fourths of the total.

With this phenomenal anticipated demand for mortgage credit, we welcome the entry of private entities into the secondary mortgage markets. The demand is more than sufficient to accommodate FNMA, FHLMC, GNMA and strong private programs. If the high demand is not choked off by high interest rates, the marketplace will provide ample opportunities to private issuers of conventional mortgage-backed securities. I want to emphasize that the conventional mortgage finance system will need strong participation by both the agencies and their newer private competitors.

The Bank of America issued the first private pass-through mortgage security in 1977. After a promising start in 1978 and 1979, the private mortgage-backed securities market essentially dried up during the tight credit years of 1980 through 1982. When money was unusually expensive, the private issuers showed that they could not squeeze their profit margins sufficiently to deliver mortgages at rates that people could afford. We are glad to have them in the markets, but expect them to be fair weather friends. In boom years the private issuers can help meet the credit demand, but when the housing industry declines again, the private issuers are likely to abandon the market. It will continue to be up to FNMA, FHLMC and GNMA to provide support in down years.

In addition, the private issuers are required by bond rating agencies to have more conservative underwriting standards than do FNMA and FHLMC. These standards penalize urban areas and young first-time homebuyers. For example, the Residential Funding Corporation (RFC) does not buy mortgages on condominiums over three stories high or on manufactured housing. A number of areas in California that may be subject to earthquakes are totally excluded.

The mortgage-backed securities market is the key to home finance in the future. GNMA, FNMA, and FHLMC have pioneered this market and are refining it to deliver mortgages to the public as efficiently as possible. Their presence in these markets is vital to the provision of housing finance. They are finding the means to keep housing investment attractive and competitive with other investments. They are sustaining the primary lenders with markets for the mortgages they originate. There is ample room for new actors to complement and perhaps improve their efforts.

In the remainder of my statement, I would like to address a number of the legislative proposals advanced by FNMA and FHLMC.

MORTGAGE PURCHASE LIMITS

We urge Congress to eliminate the statutory method for determining maximum limits for mortgage loans purchased by FNMA and FHLMC. This Committee approved such an amendment last year, and we urge you to include that provision in a Committee amendment. As explained in Committee Report No. 97-463, to accompany the Housing and Community Development Amendments of 1982, "Removal of the limits will enable the secondary market to more fully support primary lenders. Congress removed all such restrictions on savings and loan associations and other originators in 1980." FNMA and FHLMC should be able to set mortgage limits based on market conditions.

Increased limits would enable FNMA and FHLMC to serve higher cost areas which have been unfairly penalized by the current single nationwide mortgage limit of $108,300 on single family mortgages. A change in this limit would respond positively to the escalation in housing prices. In 1982 the average single family home price in 19 SMSAs went above the maximum mortgage limit of FNMA and FHLMC. Buyers of average-priced houses in relatively high cost markets are being forced to pay a premium for loans based on the local financial institution's inability to sell the mortgages on the secondary market. The change in the limit would help FNMA and FHLMC continue to provide liquidity to primary mortgage lenders to serve mortgage demand nationwide.

Some are fearful that if FNMA and FHLMC begin buying mortgages above the current limits, they will tend to reduce their activity in lower cost mortgages. The fear is not warranted. The vast majority of the mortgages bought by FNMA and FHLMC are well below the limits. Their charters commit them to serve the entire market up to their legal limits, and they have shown every willingness to do so.

The ability of FNMA and FHLMC to buy mortgages above current limits will not stifle the growth of a private secondary market. The market for both is a multi-billion dollar opportunity. Total originations in 1983 are estimated at $150 billion. Future years should be higher given the demand projected. FNMA and FHLMC have limits of $108,300 for single family homes. If we assume a loan-to-value ratio of 75 percent, then FNMA and FHLMC cannot buy mortgages on existing homes costing more than $145,000. We estimate that homes costing more than $145,000 account for 20 percent of the total dollar volume of sales which is $30 billion. Private security issuers indicate that they want to monopolize this market for themselves.

The entry of FNMA and FHLMC into this market would still leave billions of dollars of market for the private entities. Yet the private mortgage securities issuers argue that they cannot compete with FNMA and FHLMC because their quasi-governmental status and size enables them to underprice the private entities. FNMA and FHLMC will be competitive but not unfairly so. Competition from them will benefit the homebuyer because they will force the private entities to be more efficient and to lower their premiums. We understand that one private mortgage securities issuer is charging interest rates about one-half percent higher than necessary in order to limit its volume to levels it can process. The issuer is relatively new and its efficiency will undoubtedly go up. But its rates and those of the private issurers will only drop if they have to compete.

In most major metropolitan areas there are thrift institutions and others offering fixed rate mortgages at rates below FNMA and FHLMC. They have done so not only because of the size of the market, as we have pointed out, but also because of the potential returns. We are confident that the private sector has the capacity now to compete with FNMA and FHLMC, and will do so whenever they see the potential for profits.

If the Committee decides against complete removal of the mortgage limits for FNMA and FHLMC, we recommend that both entities be allowed to purchase mortgages up to 150 percent of the current limits. This approach would be less cumbersome to administer than a percentage of investments "basket" approach.

FNMA NON-RESIDENTIAL MORTGAGE PURCHASES

FNMA is seeking authority to purchase non-residential mortgages that serve the needs of residents of subdivisions, neighborhoods, housing projects or other residential areas. FNMA is requesting the authority to put 5 percent of its prior year's purchases into such mortgages during the first year and 10 percent thereafter. We urge the Committee to approve this authority for FNMA. It would help FNMA serve the large number of homebuilders who have diversified their businesses into commercial and related real estate markets. Many development projects involve mixed commercial and residential uses. The developer finances, plans and carries out these projects as a whole. The ability of the secondary market to purchase the entire financing would greatly facilitate planned unit developments and small mixed use developments. In addition, some commercial buildings and retail facilities that serve community needs could be made more feasible through FNMA secondary market support. We would support limiting FNMA's power to use this authority to buy mortgages secured by neighborhood commercial, professional and retail shopping facilities.

This limited diversification of assets would help free FNMA of the risks it faces with interest rate changes. The shorter maturities and other features of mortgages on non-residential properties will help FNMA match its assets with its liabilities. More stability in its earnings over the interest rate cycle will help FNMA borrow at lower rates and charge lower rates to lenders who sell to FNMA. The net result will be an even sounder FNMA, better able to serve housing markets. We see no reason for the Department of Housing and Urban Development to have prior approval authority this program. That extra bureaucratic step is not necessary for reasons which we will explain below.

PURCHASE OF SECOND MORTGAGES

Mr. Chairman, we want to ensure that the capital for housing is used for housing purposes. At present, both FNMA and FHLMC can deal in conventional mortgages secured by second liens on one-to-four family residences. For FNMA, there are no restrictions on the use of the proceeds. For FHLMC, the proceeds must be used for home improvement or energy conservation purposes. FHLMC would like to remove the limitations. We are not concerned with the purposes to which homeowners put loans they obtain on the security of second mortgages. We are greatly concerned, however, that FNMA and FHLMC's resources are being diverted away from housing and into consumer and other areas of credit. FNMA and FHLMC's aim should remain the financing of housing and closely-related real estate.

We recommend that the proceeds of second mortgages of FNMA and FHLMC be restricted to purchase money mortgages, home improvement loans, and energy conservation. Purchase money mortgages are simply mortgages extended so that the borrower can buy a dwelling. FHLMC currently operates with tighter restrictions. Both entities could administer these provisions by simply having the lender warrant that a loan is for a permissible purpose.

Should the Committee choose not to restrict the proceeds, then we recommend that the maximum amount of a second or subordinate mortgage purchased should be limited to $50,000 for single family residences or $60,000 for two-to-four family residences. FNMA and FHLMC should be able to purchase these mortgages regardless of the size of the first mortgage on the property. The first and subordinate mortgages should not have to be within the first mortgage purchase limit for FNMA and FHLMC because that would severely curtail the usefulness of the subordinate mortgages as a means to ease the purchase or refinance of homes.

Home sales often involve two mortgages. Many times a first mortgage will be sold to FHLMC and a second to FNMA, or the home seller may take back a second mortgage to make the home purchase possible. The authority to buy subordinate mortgages should sunset at the end of two years. This will give Congress the opportunity to evaluate the impact of these programs on housing finance and decide if the programs should be renewed.

FNMA's AUTHORITY TO MAKE LOANS ON THE SECURITY OF MORTGAGES

FNMA has asked Congress to repeal the limitations on its loans on the security of mortgages. We strongly support this amendment because it will help deliver more financing to homebuyers. Presently, FNMA can lend to home builders who are holding mortgages on properties that they have built. The loan term cannot exceed 12 months, with another 12 month extension. The loan amounts are limited to 90 percent of the unpaid principal balances of the mortgages that secure the loans. Removal of these limitations would enable FNMA to support bond programs that builders are establishing to finance their customers' purchases. Under "builder bond" programs, builders finance their own customers' purchases and then sell taxable bonds with the mortgages as collateral. In some markets, these bonds result in more favorable interest rates than comparable pass-through securities. Builder bond programs have become the primary financing tool for the nation's largest building companies and are becoming feasible for groups of smaller builders. We believe that FNMA should be permitted to participate in this increasingly important segment of the market.

FNMA'S AUTHORITY TO GUARANTEE MORTGAGE-BACKED SECURITIES

FNMA has requested authority to guarantee mortgage-backed securities issued by other entities. We support this request as a means to give FNMA more flexibility. Under the amendment, FNMA would not have to buy and then resell the mortgages as securities. It could simply review pools offered to it and place its guarantee on the private issuer pools that meet its underwriting guidelines. This technique enhances the efficiency of the mortgage security packaging and marketing and enables mortgages to be sold at lower rates. By encouraging competition among a large number of private lender/issuer institutions, a guaranty program insures that these benefits are passed on to homebuyers. For example, the GNMA mortgage-backed security program, which is a guaranty program with hundreds of active issuers, delivers mortgages to homebuyers at one-half percent above the yield to investors.

OTHER PROPOSALS

We urge the Committee to approve FNMA's request that the loan-to-value ratio restriction on multifamily mortgages it buys be removed. That would help provide financing for the growing demand for multifamily residences. In addition, we support FNMA's request for the elimination of the power of the Secretary of Housing and Urban Development to approve its new mortgage programs. HUD has been unnecessarily slow in granting approval for much needed programs. FNMA asked for HUD's approval of a new multifamily program in 1977-78 but gave up the attempt after lengthy negotiations. When FNMA renewed the request in September of 1982, it took HUD 6 months to make a decision, finally approving in February. FNMA's management has shown itself remarkably capable of developing programs to meet market needs. The change would increase FNMA's efficiency while leaving HUD and Congress with sufficient oversight responsibility over FNMA. The reports would contain valuable information on the volume and breakdown of mortgages purchased by FNMA and mortgage-backed securities, including non-residential mortgages, second mortgages, and FNMA's activites on behalf of low and moderate income housing. We support this approach as an essential means to evaluate such activities and improve the Congressional review process. We also support the remainder of FNMA's legislative proposals.

Lastly, we endorse FHLMC's request that it be given authority to purchase loans insured by state housing finance agencies. That authority will further stimulate the flow of funds into housing and support the goals of these state agencies.

Mr. Chairman, I appreciate the opportunity to present NAHB's views on these extremely important legislative proposals. American homebuyers will depend on the secondary mortgage market in the 1980s more than ever before. It will provide the sources of financing that our families need to obtain decent, affordable housing. I would be pleased to answer any questions that you may have about our views.

STUART A. DAVIS, REGIONAL VICE PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Mr. DAVIS. Thank you, Mr. Chairman. My name is Stuart Davis, I'm here on behalf of approximately 600,000 members of the National Association of Realtors, comprised of individuals involved in every facet of the real estate business. I appreciate this opportunity and would like to commend you for setting this day of hearings to examine the Nation's federally chartered secondary mortgage markets.

For realtors, homebuilders, materials suppliers, and most importantly, prospective home buyers, these congressionally chartered, semiprivate operated mortgage entities are vital. Since the financial marketplace is changing so rapidly, it was very timely for this subcommittee to review the current operating ground rules for the Federal Home Loan Mortgage Corp. and the Federal National Mortgage Association.

For the past 40 years we have, Mr. Chairman, had affordable mortgages originated and held profitably by depository institutions, primarily savings and loan associations, who derived their funds from inexpensive regulated savings accounts. However, this system by and large is not functioning in today's market. More and more mortgages are being packaged and sold by the originating lender to investors in the secondary market.

Currently, the bulk of conventional mortgages sold in the secondary market are sold to either FNMA or FHLMC. New private sources of funds are emerging to provide a larger secondary market for those mortgages.

The new players are in their formative stages, and the Congress must act to allow FNMA and FHLMC to shoulder a growing burden while fostering an environment that is healthy to the newly emerging private secondary markets, such as the Residential Funding Corp., RFC, and the General Electric Credit Corp., GECC. Under current law, Mr. Chairman, FNMA and FHLMC can only purchase mortgages below $108,300. This artificial ceiling has prohibited these secondary markets from operating in higher cost areas.

Since the Nation's housing markets are not uniform from coast to coast, a modest house in one area cannot be funded by FNMA or FHLMC, while perhaps a relative mansion in an inexpensive area can.

HIGHER MORTGAGE LIMITS FOR FNMA/FHLMC

Mr. Chairman, our industry needs higher mortgage limits for FNMA and FHLMC. We believe that legislation can be drafted to raise these limits and still address the concerns of those new entrants into the secondary market. For example, we would suggest that FNMA and FHLMC mortgage limits be raised by a certain percent of the existing statutory mortgage ceiling, perhaps controlled either by one limiting the higher cost mortgages to those areas determined by the Department of Housing and Urban Development to the high-cost areas or to creating a basket whereby FNMA and FHLMC could purchase up to a certain number of these higher-priced mortgages.

The size of the market in question is also so large that there is ample room for FNMA and FHLMC and the newly emerging private operations. We expect 1983's mortgage origination volume to be in the area of $140 billion. If you assume that 25 percent of this volume will be in mortgages over the FNMA and FHLMC limit, that leaves $35 billion in these mortgages outside the current FNMA/FHLMC lending sphere.

It's clear if the FNMA proposal of a basket is enacted, based on a percentage of the previous year's activities, private purchasers will still have an enormous market in which to operate.

We would urge this committee to act to raise FNMA and FHLMC's mortgage ceilings to support a rebounding housing market, especially in those areas not now served by these institutions. This legislation can be fashioned to protect the developing and emerging private secondary markets which, as yet, cannot provide the measures needed to sustain anticipated demand.

Mr. Chairman, as you know, the National Association of Realtors was very much opposed to the initial proposal of FNMA to expand its assets. We have held many discussions with FNMA and believe that we have arrived at a legislative proposal that: First, assures FNMA's continued support for housing; and second, assures FNMA's continued survival, if rates should return—God forbid—to last year's levels.

We believe that FNMA's congressionally chartered commitment to housing will be retained, should the Congress act to propose new asset powers needed by FNMA, due in large part to its current portfolio. Revised legislation is structured to provide incentives for FNMA to remain in housing, since any new asset power is based upon the previous year's mortgage purchase of mortgages, and these new nonresidential mortgages must support housing as ancillary investments in primarily housing-oriented developments.

We believe the provision authorizing HUD to review this new program adds an additional dimension and safeguard to the process and the limited nature of the proposal will provide the Congress with an opportunity to review the results of any new authority with ample time to correct any problems, should they arise.

Mr. Chairman, we support FHLMC's legislative package, which would improve its ability to serve housing. We've already addressed the need to lengthen FHLMC's mortgage limits. We also support their efforts to secure mobile homes, secondary mortgages, and State-insured mortgages. We urge the committee to provide FHLMC with any new asset powers it recommends for FNMA and provide, however, that such new asset powers are designed to encourage greater mortgage holdings by FHLMC.

Thank you, Mr. Chairman. I'll make it! [Laughter.]

[Complete statement follows:]

STATEMENT
OF STUART A. DAVIS
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
before the
SENATE SUBCOMMITTEE ON HOUSING
AND URBAN AFFAIRS

Mr. Chairman, I am here today on behalf of the approximately 600,000 members of the NATIONAL ASSOCIATION OF REALTORS® comprised of individuals involved in every facet of the real estate business. I appreciate this opportunity and would like to commend you for setting aside this day of hearings to examine the nation's federally chartered secondary mortgage markets.

For REALTORS®, homebuilders, materials suppliers, and most importantly, prospective homebuyers, these congressionally chartered, semi-privately operated mortgage entities are vital. Since the financial marketplace is changing so rapidly, as was addressed in last year's major financial restructuring bill, the Garn/St Germain Depository Institutions Act of 1982, it is very timely for this subcommittee to review the current operating groundrules for the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA).

THE IMPORTANCE OF SECONDARY MARKETS

For the past forty years we have had affordable mortgages originated and held profitably by depository institutions, primarily savings and loans, who derived their funds from inexpensive, regulated savings accounts. However, this system cannot function in today's economy. More and more mortgages will be sold by the lender that originated the loan to investors in the secondary market. While approximately thirty percent of all loans originated by lenders were sold in 1982, by the end of the decade over eighty percent of all mortgages will be financed by sales to investors in the secondary market. The question is: will the secondary markets be able to do the job.

Currently, the bulk of conventional mortgages sold in the secondary market are sold to either the Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (FHLMC). These two institutions will play an even more important role in supplying future housing credit, and new private sources of funds are emerging to provide a larger secondary market for these mortgages.

However, the new players are in their formative stages, and the Congress must act to allow FNMA and FHLMC to shoulder a growing burden while fostering an environment that is healthy to the newly emerging private secondary markets such as the Residential Funding Corporation (RFC) and the General Electric Credit Corporation (GECC). An important factor in this equation is that housing is improving from its worst depression in forty years and that the Congress should not hinder the recovery of such an important sector of the economy. We would like to turn now to issues raised by the legislation affecting FNMA and FHLMC.

FNMA/FHLMC MORTGAGE LIMITS

Under current law, FNMA and FHLMC can only purchase mortgages below $108,300. In spite of the increased importance of secondary markets, homebuyers seeking mortgages over that amount in many parts of the country must often put more money down if any lender can be found willing to make that loan. Often the terms are not as favorable.

This artificial ceiling has therefore prohibited these secondary markets from operating in higher cost areas. Since the nation's housing markets are not uniform from coast to coast, - a moderate house in one area cannot be funded by FNMA or FHLMC while a relative mansion in an inexpensive area can. Not only is this inequitable, it restricts these agencies from access to an important segment of the market.

Mr. Chairman, our industry needs higher mortgage limits for FNMA and FHLMC. We are not asking for an outright removal of the limits, but we do need higher limits to reflect higher housing costs in parts of the country. Raising the limits somewhat will not harm the survival of the RFC and GECC as some have suggested. It is understandable that the RFC and GECC would not want any competition, but the market in question is too large to be dominated by any single participant, including FNMA or FHLMC.

We believe that legislation could be drafted to address concerns of those new entrants to the secondary market while also raising FNMA/FHLMC mortgage limits. We would suggest that the FNMA/FHLMC mortgage limits be raised by a certain percent of the existing statutory mortgage ceiling, $108,300. This increase could also be controlled either by (1) limiting the higher cost of mortgages to those areas determined by the Department of Housing and Urban Development to be high cost areas or (2) creating a "basket" whereby FNMA and FHLMC could purchase up to a certain amount of these higher priced mortgages.

This proposal has several safeguards to assure new secondary market operations of a healthy future in the mortgage market should their corporate commitment to housing remain firm. First, they would have no competition at all from the FNMA or FHLMC in the market for mortgages above the higher limit and their own mortgage limits. Second, the higher mortgage ceiling for FNMA and FHLMC would be limited by either geographical or volume restrictions, providing the totally private market with a healthy share of the market in the limited new mortgages that FNMA and FHLMC could purchase.

The size of the market in question is also so large that FNMA and FHLMC could not purchase all the loans. We expect 1983's mortgage origination volume to be in the area of $140 billion. If you assume that 25% of this volume will be in mortgages over the FNMA/FHLMC mortgage limit, that leaves $35 billion of mortgages that will be originated next year that cannot be purchased by these institutions. It is clear that, if the FNMA proposal of a "basket," based on a percentage of the previous year's activity, is enacted, that private mortgage purchasers will have a huge market in which to operate.

We would urge this committee to act to raise FNMA's and FHLMC's mortgage ceilings to support a rebounding housing market, especially in areas not now served by these institutions. This legislation can be fashioned to protect the development of the private secondary markets that cannot now provide major support to housing.

NEW ASSET POWERS FOR FNMA

FNMA has recently earned a slim profit for its shareholders and now is somewhat more removed from the brink of insolvency that had so many of us in the housing industry so concerned last year. However, this recent episode should serve as a lesson to all of us concerned about housing that steps should be taken to stabilize the position of FNMA.

FNMA's problems stem from its $70 billion portfolio that is comprised of long-term fixed rate mortgages. This portfolio has not risen with FNMA's cost of funds, and the agency is facing many of the problems confronting savings and loans which sought the relief addressed in last year's Garn bill.

Mr. Chairman, as you know, the NATIONAL ASSOCIATION OF REALTORS® was very much opposed to the initial proposal of FNMA to expand its asset powers. We have held many discussions with FNMA and believe that we have arrived at a legislative proposal that will (1) assure FNMA's continued support for housing and (2) assure FNMA's continued survival if rates should return to last year's levels.

While the initial FNMA proposal would have authorized the purchase of any loan authorized for savings and loans, the revised FNMA proposal limits these new loans to "mortgages on non-residential facilities serving the needs of residents of the subdivisions, neighborhoods, housing projects, or other residential areas in which such facilities are located." Further this authority would be limited to 5% of the previous year's mortgage purchase activity, with an additional 5% in the next year.

As you can no doubt appreciate, the membership of the NATIONAL ASSOCIATION OF REALTORS® is primarily interested in the development of sources of residential mortgage credit. However, we believe that FNMA's congressionally chartered commitment to housing will be retained should the Congress enact its proposed new asset powers. By making FNMA a more stable operation, better able to withstand fluctuating interest rates, we believe that it is possible to even strengthen FNMA's support for housing.

First, the amendment is structured to provide incentives for FNMA to remain in housing, since any new asset power authority is based on the previous year's purchase of mortgages. Second, these new non-residential mortgages must support housing. Downtown office complexes and race tracks are two examples of non-residential projects not eligible for purchase, even though they could conceivably be linked to residential areas. We believe that allowing HUD to review this new program will add an additional safeguard to the process.

Finally, we believe the phase-in nature of the amendment provides the Congress with an opportunity to review the results of any new authority with ample time to correct any problems should they arise.

HUD OVERSIGHT OF FNMA

HUD has traditionally been the regulator of FNMA and this has caused some problems in the past. Too often we have seen FNMA proposed programs languish in HUD. In a financial environment that sometimes changes daily, these delays in regulatory approval are unnecessary.

We support FNMA's proposals to establish a better institutional relationship between HUD and FNMA. First, HUD will be required to respond in a timely fashion (45-60 days) to request action by FNMA under its Charter. This strikes an equitable balance between regulatory oversight as well as the timeliness the marketplace requires. We are also in support of the requirement of an annual report by HUD on FNMA's role in supporting housing.

However, we still believe that HUD has a constructive oversight role to play, which is why we support HUD review of FNMA's program should it receive new asset powers.

FHLMC LEGISLATION PACKAGE

Mr. Chairman, we support FHLMC's legislative package which will improve its ability to serve housing. We have already addressed the need to lift FHLMC's mortgage limits, but we also support their efforts to purchase loans secured by mobile homes, second mortgages, and state agency insured mortgages. Mobile homes are an attractive cost-reducing housing alternative that can make home ownership a reality for many prospective buyers. Allowing FHLMC to purchase these loans will make this housing option even more viable.

We would urge the Committee to provide FHLMC with any new asset powers it recommends for FNMA. However, such new asset powers should be designed to encourage greater mortgage holdings by FHLMC since FNMA needs these powers due in large part to its portfolio.

Mr. Chairman, I appreciate the opportunity to have addressed the subcommittee and am ready to answer any of your questions.

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,806 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 600,000 persons actively engaged in sales, brokerage, management, counselling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

Elected Officers are: President Harley W. Snyder, Valparaiso, Indiana; President-elect Donald H. Treadwell, Sr., Southgate, Michigan; First Vice President David Roberts, Mobile, Alabama; Treasurer Budd Krones, Tucson, Arizona.

The Chief Administrative Officer is Jack Carlson, Executive Vice President and Chief Economist.

The Senior Vice President, Government Affairs is Albert E. Abrahams and the Vice President and Legislative Counsel, Government Affairs is Gil Thurm.

Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington Office is located at 777 14th Street, N.W., Washington, D.C. 20005. Telephone (202) 383-1000.

REALTOR®

Senator HEINZ. Thank you, Mr. Davis. Very well timed.
Mr. Kendall.

LEON KENDALL, PRESIDENT, MORTGAGE INSURANCE COMPANIES OF AMERICA

Mr. KENDALL. Thank you, Mr. Chairman. I am Leon Kendall, President of the Mortgage Insurance Companies of America. I, too, will summarize our association's prepared statement and ask that the full statement be included in the record.

The subject is secondary markets, but it really is primary markets. I believe that the policies Congress formulates for the secondary markets will determine how mortgage credit accesses the general capital markets during the rest of the 1980's. The changes in the local thrift institutions, as Mr. Davis mentioned, over regulation Q make this a very fundamental issue that we face today. In the long run, we're talking about the form and locus of market power in housing finance. How will the balance between public agencies and private companies be struck?

We submit that the principal enumerated in 1949 by the 81st Congress continues to be sound doctrine. Let me quote one sentence from the Landmark Housing Act.

> The policy to be followed in attaining the national housing objective, hereby established, shall be (1) Private enterprise shall be encouraged to serve as large a part of the total need as it can, (2) governmental assistance shall be utilized where feasible to enable private enterprise to serve more of the total need.

Another important reference point is the recently concluded public/private balance debate that has gone through this Congress known as deregulation and the increased use of the marketplace and price competition among airlines, truckers, and financial institutions. Public policy in 1970 created a natural monopoly for FNMA and FHLMC. The justification was the inability and absence of private firms to perform in a manner that would realistically achieve the housing policy objectives of that time. The operations of FNMA and FHLMC have been quite successful and the management of both agencies is to be complimented.

PRIVATE FIRMS TAKE BIG STEPS TO CREATE SECONDARY MARKET SERVICES

There's a great deal more they can do, even within existing powers. Private firms have also taken big steps to create secondary market services.

You heard from two such individuals earlier during this panel. I might simply run down a list of organizations that have been created in the last several years, in the worst of times, that might well have an opportunity to do even more with the wind to their back. They include mortgage conduit companies in our industry, such as Maggie Mae, Pennie Mae, Connie Mac, Verax Mortage, AMIC, GE, Foremost, and others who have provided passthrough issues among homebuilders. Home-Ec is an effort by the NAHB and the major builders. U.S. Home, Ryan Homes, and Pulte have major mortgage programs.

We have the beginnings of a Rennie Mae, we have Shelter-Net, we have ERA and Century 21, Merrill Realty, Cities Corp., Homeowners, all active in the area. There's even a mutual fund contemplated to directly tap individual investors. The Home Investor Fund is willing to manage it.

Among individual companies, Bankamerica, Home Savings, Glendale Federal have done major passthroughs and have the expertise to do more.

Mortgage-backed bonds, any number of AAA-rated issues by savings and loans and savings investment bankers, Merrill Lynch mortgage-backed securities, Sears-Dean Witter, Salomon, and growing lists of companies aggressively adding talent, people, and resources to the area. All this is still embryonic.

I submit that now that housing is running with the wind, the private market should be given an opportunity to show what it can do and contribute before the market power of the agencies is materially increased.

MICA believes that the federally sponsored agencies, so long as they are federally backed, would crowd out and keep off the playing field the private entrants. We believe that the charter amendments proposed must be viewed against the background of market power and the private-public balance.

In evaluating these suggestions as proposals in that context, we come down in opposition against the expansion of assets' powers, permitting loans on the securities of mortagages, increasing loan limits, and permitting guaranteeing of mortgage-backed securities.

We have no objections to the technical amendments which would create equity between the agencies, nor to the changes in Fannie Mae's board composition, voting rights, or HUD oversight, provided Congress continues to believe it has appropriate control over the social objectives it has for that agency.

Summing up, there should be plenty of business to go around in housing during 1983 and 1984. It is an excellent time to give private forces a chance to see what they can do.

Encouragement of the TIM's proposal would help a great deal.

Within this context, we recommend that the committee reject any charter enhancements for the agencies. At the same time, the committee might ask the agencies for a comprehensive privatization plan and a timetable to accomplish it.

If, and as the agencies forego their Federal guarantee status, their powers could be enlarged to whatever extent State and Federal laws and regulations and competition would allow.

[The complete statement follows:]

STATEMENT OF LEON T. KENDALL, PRESIDENT, MORTGAGE INSURANCE COMPANIES OF AMERICA AND CHAIRMAN, MORTGAGE GUARANTY INSURANCE CORPORATION, MILWAUKEE, WISCONSIN, BEFORE THE SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS IN REGARD TO PROPOSED CHANGES IN THE FHLMC AND FNMA CHARTER ACTS.

May 5, 1983

Mr. Chairman and Members of the Subcommittee:

I am Leon T. Kendall representing the Mortgage Insurance Companies of America (MICA). I appreciate the opportunity to appear before this Subcommittee today.

We are pleased that this Subcommittee is determined to carefully examine the direction the government sponsored secondary home mortgage market is taking. My testimony focuses upon the need for balance between the private sector and Federal secondary market agencies during the transition that is occurring in housing finance. A parallel can be made to recent bank deregulation efforts. Just as important steps have been taken to remove unnecessary government involvement that interferes with private market forces among financial intermediaries, we must take steps so that the secondary market offers the opportunities to grow under the same philosophy - with maximum reliance upon the private sector and lesser reliance upon Federal support and guarantees.

MICA consists of thirteen domestic private mortgage insurance companies and one Canadian company whose insurance-in-force on December 31, 1982 was $124.97 billion. The national officers are Leon T. Kendall (Chairman of the Board of Mortgage Guaranty Insurance Corporation), Milwaukee, Wisconsin, President; William A. Simpson (President of Republic Mortgage Insurance Company), Winston-Salem, North Carolina, Vice President; Claude E. Pope (President of American Mortgage Insurance Company), Raleigh, North Carolina, Treasurer; Henry D. Felton (President of Commercial Credit Mortgage Insurance Company), Baltimore, Maryland, Secretary; and John C. Williamson and Steven P. Doehler, Washington, D.C.

By way of background, MICA is a trade association of the private mortgage insurance industry. Starting in 1956 with one company, which was capitalized with $250,000, the industry has grown to fifteen domestic insurers with an aggregate policyholders reserve (funds available for the payment of claims) of more than $1.65 billion at the end of 1982. In the first quarter century of the industry's existence, it has helped millions of households acquire a home of their own. Using marketing efficiencies to serve the same market as the unsubsidized FHA program, the private mortgage insurance industry, in 1982 did twice the volume of FHA and at approximately half the premium costs to the homebuyer. These facts are important because they demonstrate that given an opportunity, a flourishing, sound, and financially credible private industry can be introduced into a market heretofore served only by the government.

Housing policy should continue to call for government assistance to be utilized only where private enterprise cannot fulfill a need. This is in keeping with the national housing policy enunciated in 1949: "The policy to be followed in attaining the national housing objective hereby established shall be: (1) private enterprise shall be encouraged to serve as large a part of the total need as it can; (2) governmental assistance shall be utilized where feasible to enable private enterprise to serve more of the total need." [Public Law, 171, 81st Congress; 63 Stat. 413, 42 U.S.C. 1441].

Public policy in 1970 created a natural monopoly for FNMA and FHLMC. The justification for this governmental market intervention was the inability and absence of private firms to perform in a manner that would realistically achieve the housing policy objectives at that time. During the decade of the 1970's the secondary market increased its importance to the delivery of housing funds due to deposit rate deregulation and other factors. Private firms during this time have also taken great steps to develop secondary markets and services including a major role in the growth of the secondary agencies.

The secondary markets in truth have become a primary source of mortgage funds and along with the question of affordability, this is the greatest challenge facing the housing market. During the 1970's approximately 3 out of every 10 home loans were funded with secondary market assistance and 7 out of 10 were originated, serviced and funded locally by institutions that were perhaps 50 miles or less from the mortgaged property. These proportions have reversed. According to testimony already received by the Subcommittee in 1982, as many as 7 out of 10 loans originated were purchased by secondary market investors. The secondary market clearly provides major support for local mortgage originations. The policies Congress formulates for the secondary market and especially as to how mortgage credit accesses the general capital markets will determine how mortgage finance will do its job in the 1980's and beyond.

MICA has consistently supported a greater role for a private secondary market. Last June, in testimony on a bill to expand and reorganize FHLMC, we stated:

> "We believe in the long run that both FHLMC and FNMA should become fully private, that is, sever their respective emergency credit lines to a Federal agency and the Treasury. However, at this point in time neither FHLMC nor FNMA can perform its current role without Federal backing. . . we urge the Congress to insure that their involvement in the housing market continues to have a "social" orientation as a quid pro quo for the government support. In this regard. . . we feel the express desire to have the full flexibility and profit potential of a private corporation should not be the primary operating philosophy so long as the Federal Government is exposed to liability for the operations of these agencies."

Hearings on H.R.6442, June 3, 1982, Committee on Banking, Finance and Urban Affairs, House of Representatives.

Our support for the FHLMC recapitalization was conditioned on the belief that FHLMC was making a reasonable movement toward privatization and would closely adhere to the policy direction provided by the Congress. Our view has recently been validated by the statements of Kenneth Thygerson, President of FHLMC, before this Subcommittee in discussing the evolving role of the secondary market and his legislative recommendations for FHLMC. We commend his decision to weigh FHLMC's "corporate goals against the realities of sound public policy" and willingness to "look to the Congress to provide direction."

Last June FNMA opposed the FHLMC recapitalization legislation arguing against expanding government involvement and that passage of the bill "would be premature because the expanded role of FHLMC would discourage the entrance and expansion of private firms into the secondary market."

Further, when questioned as to how the spokesman for the mortgage insurance industry could support the legislation, FNMA's Chairman responded:

> "Mr. Kendall is entitled to his opinion, but he has overlooked a crucial point. If FHLMC is allowed to expand under H.R.6442, the secondary market would become more of a Federal market than it is today. The reason the market is "so big" is the ease of access by private "players"; it won't be "big" if private "players" are crowded out by more Federally sponsored participation than is absolutely necessary to provide liquidity for home mortgages. FHLMC's recapitalization is not required for this purpose. . . If I were still a private mortgage insurance executive like Mr. Kendall, I must say in all candor I would have testified against H.R.6442."

MICA would agree totally with the FNMA spokesman that "crowding out" by Federally sponsored participation with monopoly power presents a real danger; and it doesn't make any difference which government sponsored agency is doing the crowding out. Amendments from either FHLMC or FNMA must be carefully evaluated as to whether they will increase government involvement and create new barriers to entry by private firms into areas of housing finance. Congress should obtain a commitment from these secondary agencies that they will not exploit special preferences flowing from their Federal tie to expand competitive advantages within markets that private firms are just beginning to enter.

The housing market has only recently begun to demonstrate strength and many of the innovative private sector ideas developed during the stressful days of the past few years should be given an opportunity to show what they can contribute. Examples are the mortgage securities programs of private conduits of mortgage insurers, investment bankers, homebuilders, and the Realtors. The TIM initiatives should attract further entries. MICA would support efforts that move toward greater access by private players into the secondary market as being in the long run interest of housing and consistent with the national housing policy.

The success of early entrants and the potential promised suggests that this Congress need not rush ahead with significant expansion of FHLMC and FNMA authorities. In fact, any enhancements without a formal agreement as to the agencies' privatization schedule would hurt the private market. With mortgage rates having fallen in the past year, FNMA is once again profitable. One must ask the question why is it imperative that it obtain new competitive authorities now; especially when one remembers FNMA's own argument in June of 1982 that such powers would reduce access by private players.

The key issue before the Subcommittee is the fundamental question of balance between goverument and private market efforts as we bring new credit resources to housing through the secondary markets. What effect will new powers of the Federally sponsored agencies have on meeting housing needs? What effects will they have on existing services or innovative plans of private firms unable to compete with an expansion of the natural monopoly?

It is in this context that MICA has considered the amendments requested by FHLMC and FNMA for the current housing authorization legislation. We have no objections to FHLMC amendments for the authority to make a secondary market for manufactured homes, junior liens, state agency mortgage loans. They are technical enhancements of existing functions and we would support giving FNMA comparable authorities to their existing functions.

On the question of permitting FHLMC and FNMA higher mortgage loan limits, there are members of MICA who would support a raising of the limits because it could deliver immediate benefits by increasing the volume of conventional home loans funded by the capital markets. Others are opposed and view it as directly competitive with private efforts. Since MICA has long standing opposition to raising FHA limits, its opposition to higher limits on FHLMC and FNMA loans is consistent with our views of a limited government role. The $90,000 FHA limits for borrowers with incomes to qualify, resulted in 29.7 percent of the FHA unsubsidized loans in 1982 going to families earning $40,000 and over annually. Whether or not one accepts the evidence that private insurers serve all homebuyers, low income as well as high, all should agree that it is the lower income families who are the least adequately served by private and government programs. If government resources are limited, who should they go to? If Congress were to limit government-supported loans just to households earning the median income or less, (i.e. fully half of the total households would be eligible) it would greatly reduce government competition with the private sector. There should be no doubt the upper median income households would be adequately served by competitive private insurers - if given the chance. It is time to recognize that our nation's economic strength cannot be built upon a foundation of expanded government assistance to upper income households.

Finally, we object strongly to amendments offered to increase the monopolistic competition of the government sponsored agencies over private firms. FNMA has requested authority to establish a GNMA type guarantee program to be able to guarantee a mortgage security without being required to purchase the mortgages backing the securities. This would be an expansion of FNMA and FHLMC into a guaranteeing role that the private mortgage insurance industry has been performing. Private mortgage securities could not effectively compete with securities guaranteed by FNMA or FHLMC because an investor would purchase these securities on the same basis other direct and indirect obligations of the United States are purchased. The agency securities are exempt from burdensome Federal security laws and have other advantages afforded agency securities. While private insurers are not unaccustomed to competition, this guarantee authority could, in the view of Professor Jack Guttentag, "relegate the private market to never playing more than a marginal role." Private guarantees cannot compete head to head with Federal guarantees.

In the case of FNMA, Congress would be conferring this power to a publicly held corporation. The fees generated from this proposed guarantor role would result in increased profitability permitting increasing dividends to stockholders. Mortgage bankers, who are a major group among FNMA shareholders would have an incentive to use a FNMA guarantee on a security issue regardless of the competitiveness of a private guarantee.

This potential conflict with guarantee power becomes clearer in the light of the amendment FNMA has requested to repeal the limitations on FNMA loans on the security of mortgages. Removing the term and over collateralization requirements "will enhance FNMA's ability to provide a funding means significant to certain secondary market users." Since mortgage bankers depend heavily upon short-term financing, FNMA or FHLMC (if it requested the same authority) could use the market power of their secondary purchase role for tying arrangements with this warehouse function or with the guarantee function. It would provide obvious potential advantages over private competitors. These agencies have unique corporate structures and when they assert that they need expansions of authority which technically permit natural outgrowths of their secondary market operations, Congress must be convinced changes will not create the potential for anticompetitive behavior. MICA has opposed conflicts that arise when the basic distinction between insuring and lending are discarded. We urge Congress not to discard policy principles applicable to financing activities when examining the secondary market.

FNMA is a creature of the Congress. It was created to perform a social policy objective and given quasi-government agency status. Congress gave private mortgage insurers a role in the success of FNMA and FHLMC by requiring the conventional loans the agencies purchase to carry a level of protection. This independent insuring role is an appropriate check upon the government's degree of exposure for the operations of these agencies. In a very real way, private insurers provide a secondary level of reserves protecting the Treasury and the FHLB system from the lending activity. In turn private mortgage insurers undergo a level of supervision by these agencies. This balance could be placed in jeopardy during this transition in housing finance if one of these agencies were to abuse its market power and supervisory role to obtain support for their present or potential corporate objectives. We hope the Congress will take note of this vulnerability of the marketplace as it considers the direction these government sponsored agencies should take and their methods in getting there.

In summary, the form and focus of market power in housing finance during the 1980's is the primary issue facing this committee. How will the balance between public agencies and private companies be struck? We submit that the principal enumerated by the 81st Congress in 1949 continues to be sound doctrine. The more recently expressed philosophy of deregulation and the competition it has generated among financial institutions also seems to be an appropriate reference point. Private interests and experimentation are to be preferred to expanded governments involvement and exposure. Given the fact that housing is moving nicely and shows every sign of attracting new resources into the secondary market, expansion of government agency powers would seem to be inadvisable at this time. Therefore, we would urge no action by this Committee on those amendments such as secondary market guarantee powers, loan limits, loans on the security of mortgages and non-residential mortgages which do expand powers.

To do otherwise would effectively upset the balance between the two secondary market agencies and terminate the willingness of private firms to enter the market through individualized services, private placements, or by specializing initially in loans Congress had not permitted the agencies to purchase.

The agencies have evidenced clear plans to continue to privatize their operations in the future. There should be equally clear evidence of their willingness to give up their ties to the Federal Government. If and as that servicing takes place, new powers would seem to be very much in order for the agency. Until that point is reached, the playing field cannot be regarded as a level one. To ready an extension of monopoly power represents too great a risk for Congress to take. The availability, price and affordability of home mortgage funds for the rest of the 1980's hangs in the balance.

Senator HEINZ. Mr. Kendall, thank you very much.

Mr. Beck.

FELIX M. BECK, CHAIRMAN OF THE BOARD, MARGARETTEN & CO., INC., PERTH AMBOY, N.J.

Mr. BECK. Mr. Chairman, I'm Felix Beck, chairman of the board of Margaretten & Co., a mortgage banking firm, whose home offices are in Perth Amboy, N.J.

I also serve as MBA's first vice president.

We appreciate the opportunity to appear before you today to testify on the subject of the secondary market. Since I promised to summarize the filed statement in less than 5 minutes, I request that the full statement be included in the record.

Senator HEINZ. Without objection, so ordered.

Mr. BECK. All segments of the housing and real estate finance industry have a vital stake in the continued healthy operation and function of the secondary market.

Key to the functional effectiveness of the secondary market are FNMA and FHLMC.

MBA believes it is essential that the conditions and regulations under which these two entities function must be reflective of what is happening in the marketplace, and what their current needs and requirements are, to keep them on a steady course.

MBA strongly supports the various provisions in the legislative proposals of FNMA and FHLMC, particularly the removal or increase of mortgage purchase limits.

The current limit of $108,300 effectively excludes many potential homebuyers from access to more affordable financing, which FHLMC and FNMA have been able to offer. Homes priced above the mortgage purchase limit are no longer necessarily luxurious ones, particularly in areas with higher housing costs.

Incidentally, our statistics show that about 30 percent of the loans, by dollar volume, that are estimated to be originated in 1983 will have mortgage balances of $100,000 or more, which is, of course, at odds with some of the suggestions of the panel that the market for loans of over $108,000 only includes about 6 percent of the market, although I am talking dollar volume and it's possible they're talking units.

A number of private secondary mortgage conduits have expressed an interest in participating in the market above the FNMA-FHLMC mortgage purchase cutoff. MBA believes there'll be an ample market available to accommodate a variety of market competitors.

Both FHLMC and FNMA have a congressionally chartered public purpose to help provide affordable mortgage credit to the full income range of creditworthy borrowers in all credit cycles.

We must question whether the private market conduits will have the same commitment to a public purpose and whether these private entities have the staying power that both FHLMC and FNMA have proven to have had throughout economic cycles.

MBA also supports FNMA's request for authority to guarantee mortgage-backed securities issued by approved lenders and a reasonable diversification of its assets.

The ability to invest in residential real estate-related financing will not only help FNMA offset the effects of interest-rate cycles in the housing markets, but also will allow Fannie Mae to serve as a more complete secondary market instrument for primary lenders.

MBA also reports the removal of loan-to-value restrictions on FNMA multifamily mortgages and the removal of the overcollateralization requirement and term restrictions on Fannie Mae loans on the security of mortgages.

We support the proposal being made to amend the Fannie Mae corporate structure, which reduces dependence on HUD for detailed guidance. These changes would allow new dimensions of expertise, capital, and interest to enrich FNMA's operation and would enhance the ability of FNMA to operate in the fast-paced capital and mortgage markets of today.

We also support FHLMC's request for authority to purchase loans secured by manufactured housing in States that classify such housing as personnel property, to purchase loans secured by junior liens and to purchase loans insured by State housing finance agencies. These are modest proposals that will enhance FHLMC's ability to support the broad spectrum of the secondary market for mortgages.

We appreciate the opportunity to appear before the subcommittee and would be happy to answer any questions you may have.

[The complete statement follows:]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005
202-861-6500

Mortgage Bankers Association of America

STATEMENT OF

FELIX M. BECK

CHAIRMAN OF THE BOARD
MARGARETTEN & COMPANY, INC.
PERTH AMBOY, NEW JERSEY

on behalf
of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES SENATE

Hearings on

Secondary Market Issues and Mortgage Foreclosures

May 5, 1983

Mr. Chairman and Members of the Subcommittee, my name is Felix Beck. I am Chairman of the Board of Margretten & Company, Inc., which is located in Perth Amboy, New Jersey. I serve as First Vice President of the Mortgage Bankers Association of America.* MBA is the trade association of the Nation's mortgage banking and real estate finance industries. Accompanying me today are Burton C. Wood, MBA's Legislative Counsel, Sharon M. Canavan, MBA's Associate Legislative Counsel, and William E. Cumberland, MBA's General Counsel.

We appreciate the opportunity to appear before you today to testify on the subjects of the secondary markets and mortgage foreclosure. MBA strongly supports the various provisions in the legislative proposals of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) pending before the Subcommittee, particularly the removal of the mortgage purchase limits and expanded asset powers.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500

With respect to the current mortgage default, delinquency, and foreclosure situation across the Nation, MBA shares everyone's concern about the effect of the recession and unemployment on the ability of families to keep their mortgages current. Title VII of the Senate Banking Committee's version of the 1983 housing bill, the "Unemployed Homeowners Relief Act of 1983," would establish a second loan guaranty program to aid persons experiencing difficulties with their mortgage payments. We believe that the current economic recovery and a projected drop in unemployment may mean that an extensive mortgage relief program is not needed at this time.

THE SECONDARY MORTGAGE MARKET - FNMA AND FHLMC

All segments of the housing and real estate finance industries have a vital stake in the continued healthy operation and function of the secondary mortgage market. Mortgage lenders, home builders, thrift institutions, commercial banks and real estate sales companies are increasingly depending upon the secondary market to bring affordable housing to the ultimate consumer, our Nation's families.

Key to this effort and to the functional effectiveness of the secondary market are FNMA and FHLMC. MBA believes it is essential that the conditions and regulations under which these two entities function must be reflective of what is happening in the marketplace and what their current needs and requirements are to keep them on a steady course. In this connection, both FHLMC and FNMA have sought several legislative amendments this year. However, none of these provisions was included in the Committee print of S 644, the "Housing and Community Development Amendments of 1983," which was the subject of the full Banking Committee's April 12 markup. Because concern had been expressed at that time that these proposals had not been the subject of hearings, these hearings were scheduled. We would like to address ourselves to the proposals.

Traditionally, thrift institutions served as intermediaries to provide the greater part of the financing for homebuyers to purchase homes. It was the thrifts who attracted capital in the form of savings deposits, and loaned it out on the security of mortgages. However, as the thrifts and other depository institutions experienced higher average costs and shorter average maturities on their savings deposits because of forces in the economy and interest rate deregulation, the long-term mortgage lending needed to support home purchases became less attractive to these financial institutions than it had been.

The result has been that the secondary mortgage market, which attracts capital from the full spectrum of investors in the nationwide capital markets, has come to play an increasingly greater role in mortgage finance for housing.

Leading in the development and expansion of the secondary market have been the two federally sponsored secondary market corporations, FHLMC and FNMA. Each of these corporations has brought innovative products to the market in the past, which have broadened and strengthened the ability of primary mortgage lenders to serve the needs of homebuying consumers. Now they are each seeking authority to expand their purchasing authority further to serve the housing market. MBA supports measures that will allow FHLMC and FNMA to increase the variety of mortgage products that can be made available to the public by lenders dealing with them. Recognizing the importance of FHLMC and FNMA in providing consumers with the ability to purchase and own homes, MBA believes that they should be free to invest in any mortgage that their experience and judgment determines will enhance their support of the housing market, without limit as to amount or type. We urge Congress to grant the removal of purchase limitations being sought by FHLMC and FNMA.

The presence of FHLMC and FNMA in the housing finance market has also served to offset the adverse effects on housing of the economic cycles that have been experienced in the past decade. During the difficult economic times of 1982, for example, FNMA purchased $15.1 billion in mortgages and guaranteed $15.5 billion in mortgage-backed securities, the highest year of activity ever. FHLMC's volume was comparably above its traditional activity. In order to continue to serve as countercyclical forces, FHLMC and FNMA must be healthy and strong.

In passing the Garn-St Germain Depository Institutions Act of 1982 and the Depository Institutions Deregulation and Monetary Control Act of 1980, Congress recognized that thrift institutions, as portfolio lenders, needed reasonable diversification in order to assure their economic viability. FNMA is also a portfolio lender, with a mortgage investment of approximately $80 billion. Reasonable diversification for FNMA is necessary, also, if FNMA is to continue to be strong and fulfill its basic mission of supporting homeownership. Whether FNMA needs as broad a diversification of asset powers as given the thrift industry in the 1980 and 1982 Acts will be explored and tested over time, but some increased freedom along the same lines of authority established for the thrifts seems indicated at this time. MBA believes that FNMA should be given the tools it needs to build itself into an institution that can withstand difficult times without being in danger of collapse. Therefore, MBA urges Congress to view the question as, how far should FNMA's asset powers be broadened, rather than whether they should be broadened at all.

Removal of the Mortgage Purchase Limits for FHLMC and FNMA

Both FHLMC and FNMA have urged that the current restrictions on the maximum mortgage purchase limits be removed or, at the minimum, increased. Although the purchase limit is adjusted annually, its relationship to housing prices will remain relatively constant. The current limit of $108,300 effectively excludes many potential FNMA and FHLMC purchases in a significant number of high cost areas.

FHLMC and FNMA package many of the loans they purchase as securities to be sold to capital market investors, and those investors would welcome larger balance loans to increase the diversity of risk associated with the collateral behind FHLMC- and FNMA-issued securities. Mortgage bankers and other lenders originate loans for sale to FHLMC and FNMA, and could expand their activities if the limits were raised. MBA, therefore, supports the removal of these restrictive limitations.

The chief benefit of such a change, however, would inure to potential home buyers who are effectively excluded from access to the more affordable financing carrying better terms that FHLMC and FNMA have been able to offer. Homes priced above the FHLMC/FNMA mortgage purchase limits are no longer necessarily luxurious ones. This is particularly true in areas with higher housing costs. It is interesting to note that in the west, the median price of an existing home was $108,000 as of February 1983—so in that region nearly half of all home sales cannot depend upon FHLMC or FNMA programs without substantial downpayments. The current maximum falls below the average price of new and existing homes in almost twenty standard metropolitan statistical areas (SMSAs). This amounts to economic discrimination, because there is a high cost adjustment for the mortgage purchase limits in only two states—Hawaii and Alaska. A comparative study of home prices by the National Relocation Service amply illustrates this point. That study indicates that geography makes a huge difference when shopping for an essentially identical home in different market areas. A home that costs $58,000 in Akron, Ohio or Buffalo, New York would be priced at $128,500 in Miami, Florida, $155,000 in Billings, Montana, $235,000 in San Francisco, California, or $120,000 in Portland, Oregon. In quoting these statistics, we have not focused on the extremes of the expensive housing markets of Orange and Los Angeles Counties, California or the New York suburbs, where comparable home prices skyrocket far above these levels.

In many cities, Federal Housing Administration (FHA) mortgage insurance is available on loans ranging up to $90,000, because of the high cost of housing in those areas, although the base FHA maximum mortgage amount is $67,500. The FHA, however, is designed to serve a more moderate profile, and these lower mortgage limits were imposed to enforce and preserve that aim. Congress recognized, nonetheless, that the FHA maximum mortgage amount needed a high cost adjustment factor to accommodate regional variations, and enacted the adjustment several years ago. It has worked well to even out regional disparities.

FHLMC and FNMA are supposed to serve a much broader income spectrum than FHA. Recognition of that policy is the fact that the obligations of the FHLMC and FNMA do not have the 100 percent full faith and credit backing of the U. S. government, making the credit they provide somewhat more expensive for the higher income sector they are mandated to serve. Yet the difference between the FHA and the FHLMC/FNMA maximum in many high cost areas is only $18,000, despite the mandate of the latter to serve a broader income spectrum than the FHA.

The effect of this discrimination is visited upon potential homebuyers in these areas in the form of generally higher interest rates or more restrictive loan terms. Many homebuyers are puzzled by the magic cutoff point of $108,300 in their efforts to secure affordable financing. The simple answer to their bewilderment is that they, as homebuyers above that point, are excluded from the benefit of participating in a highly efficient sector of the extremely competitive capital markets, via the secondary mortgage market programs offered by FHLMC and FNMA. This exclusion most often translates into higher interest rates or not being able to secure fixed rate terms for their mortgages. In many cases, this is not related to a consumer's desire to live in a luxury home, but rather to the simple happenstance of living in a geographic area where average homes carry relatively high price tags.

A number of private secondary mortgage conduits have become interested in participating and focusing, almost exclusively, in the market above the FHLMC/FNMA mortgage purchase cutoff. MBA firmly believes that the amount of demand for housing during the 1980s will be enormous, and that, therefore, there is an ample market available to supply the needs of a variety of market competitors. The presence of more, rather than less, operating entities in that market will spur competition both as to price and product.

Of the mortgage originations by loan size it is apparent that there is an enormous market in which a variety of entities can ably compete. The following table lists the average loan size for mortgage originations in 1982 and projected for 1983. It is important to note that these statistics are based on mortgage amount, rather than sales price from which a downpayment would be subtracted to arrive at the loan amount.

Mortgage Originations by Average Loan Size*

	Below $100,000	$100,000 & Above	Total Loan Originations
1982	$63 billion	$32 billion	$95 billion
1983 (est.)	$100 billion	$45 billion	$145 billion

The Garn-St Germain Depository Institutions Deregulation Act of 1982 (P.L. 97-320) provided a new world of investment opportunities for federally regulated financial institutions. While these changes were necessary to allow these entities to compete effectively in an increasingly diversified marketplace, one effect of these changes was to reduce the role these institutions now play in providing mortgage finance to home borrowers. In the past decade, not only did these lenders have a Congressional mandate to devote a specified portion of their assets to providing home mortgages, but they had a 'captive' source of low interest rate funds with which to do so. This 'hostage' supply of mortgage credit for homebuyers provided a fairly constant stream of low interest rate funds for home loans.

One of the main thrusts of the financial institutions' deregulation was the removal of the federally regulated interest rate ceilings. These ceilings effectively created a two-tiered savings system, where the financial institutions occupied the low interest rate regulated level of that system. Congress recognized the problems that existed under this system, particularly the danger of disintermediation, and removed those ceilings. We believe that the deregulation of interest rates is somewhat analagous to the current situation with the

Sources: National Association of Realtors, Bureau of Census, U.S. Department of Housing and Urban Development as compiled by the MBA Economics Department, April 1983.

*Average loan-to-value of 80 percent.

FHLMC/FNMA limits. These limitations will, in effect, create a similar two-tiered mortgage market, where FHLMC and FNMA must operate at a disadvantage to their competitors because they are not able to expand into market areas where home prices exceed the mortgage purchase limits.

The trend, since the early 1970s, to rely more heavily on the secondary mortgage market as a principle source of mortgage funds will increase during the 1980s. The secondary market provides liquidity to investors in mortgages and assurance that they will receive a return on their investment within certain expectations and presumptions. While many depository institutions will not forsake their presence in their community as lenders, they will package more of their loans and sell them into the secondary market and invest their assets in mortgage securities, rather than retain individual or whole loans in their own portfolios as they have done in the past. During the past two years, and for the first time, the secondary mortgage market provided more than 50 percent of all mortgage funds. The share of mortgage credit flowing through the secondary market will increase throughout the 1980s and any restriction on that market will unfairly penalize those dependent on the affected section of the real estate market.

Furthermore, during the 1980s, there will be a level of demand for homes reminiscent of the post-war surge of homebuying in the 1950s. The children born then are now reaching homebuying age in unprecedented numbers. Many of these families have been unable to afford to purchase homes at the high interest rates of the past three years and are now entering the market for new and existing homes. This projected market growth makes it even more important that impediments to the orderly growth of the secondary market be removed.

For this system of mortgage finance to operate efficiently, we must have a competitive secondary market. To impose mortgage purchase limits on FHLMC and FNMA at an arbitrarily low level disrupts the free secondary market, limits credit available to homebuyer in higher cost areas, and tends to raise the overall level of mortgage interest rates.

Both FHLMC and FNMA have a Congressionally chartered public purpose to provide affordable mortgage credit to the full income range of creditworthy homebuyers. Both institutions have fulfilled this role consistently. Statistics prove that they have offered mortgage finance to a varied strata of families, not just to families who could afford mortgages at the high end of the scale immediately below the mortgage purchase limits. Their average mortgage purchase price has always been well below the mandated limit, and roughly equivalent to the average purchase price of existing homes in the U.S.

Indeed, there is no incentive whatsoever for either of these entities to remove themselves from these markets. The most common argument made for lenders to prefer high balance loans is that for the same processing and servicing costs they will originate a loan that will bring more profit. This incentive simply does not exist for FHLMC and FNMA. Secondary market securities are backed by mortgages of varying amounts that add up to the security face value. Depending upon the degree of underwriting review performed by the secondary market purchaser, there may be an added increment of work for lower balance loans than for higher balance loans, but this is insignificant. In fact, the preference is not to include too many high balance loans in a given pool of mortgages, because an early payoff of a large balance loan would accelerate the return of principal to the investor beyond what the investor may have originally planned.

Not only have FHLMC and FNMA adequately fulfilled their public purpose in the past but they will continue to be subject to Federal legislative review and oversight, at least to some degree, so long as they retain their Federal charters. Their mortgage purchases will be subject to scrutiny to ensure that they will continue to provide a mortgage market for all types of purchasers.

MBA believes that the marketplace is large enough to provide ample room for a wide variety of actors. We do not have the same faith that the private secondary market conduits will have the same commitment to a public purpose as they enter this marketplace. In 1978, a variety of large financial concerns were in the process of developing and marketing conventional mortgage-backed securities. As soon as interest rates skyrocketed and the availability of money tightened in 1979, that market activity dissipated. The few securities initiatives that took place over the next few years did not come to fruition for lack of available product and inability to market sufficiently large issues. Last year, the Senate Banking Committee version of the housing authorization bill, S 2607, provided for the total removal of the FHLMC/FNMA mortgage purchase limits. There was little, if any, opposition to that provision. What, then, has made the difference this year? The answer is both simple and telling—lower interest rates have created the incentive to test the waters again. In light of this, MBA must question whether these private entities have the staying power that both FHLMC and FNMA have proven to have had throughout economic cycles. FHLMC and FNMA should be given the ability to purchase higher balance loans simply to ensure that there will be at least two alternative secondary markets for these loans during periods of rising interest rates.

Another benefit of allowing FHLMC and FNMA to provide a market for higher balance loans, on the same basis as they serve the rest of the market, is that their activity can serve to establish a benchmark for pricing private issuances and ensure that there is competitive pricing for loans in this price range. The presence of FHLMC and FNMA will simply keep the private issuers 'honest' by providing another source of competition.

MBA firmly believes that the market is big enough to accommodate a variety of competitors, and, in fact, should be broadened as much as possible so as not to exclude the entities who have had a great deal of experience in marketing conventional loans, FNMA and FHLMC. Removal of the mortgage purchase limits will allow FHLMC and FNMA to fulfill their mandate of expanding the affordability of mortgages to a greater number of consumers.

FNMA Guaranty of Mortgage-Backed Securities

FNMA has requested authority to guarantee mortgage-backed securities issued by approved lenders. Currently, FNMA may only guarantee mortgage-backed securities issued by FNMA. One of the products FNMA offers under this authority is to issue securities to a mortgage originator, based on a pool of mortgages purchased by FNMA from the originator, with the understanding that the originator will market the securities.

The requested guaranty authority would allow mortgage originating lenders to issue the securities in their own name, which some lenders wish to do, and would allow investors to easily identify the security servicer, as in the GNMA guaranteed mortgage-backed securities program. Because the GNMA program has so successfully operated with lenders as issuers, the market can be improved if FNMA can also operate in this format.

Expanded Asset Powers for FNMA

A proposal is also before the Subcommittee to give FNMA authority to purchase non-residential mortgages serving the needs of residents of subdivisions, neighborhoods, housing projects, and other residential areas, up to 10 percent, 5 percent in the first year, of the previous year's mortgage purchases by FNMA. MBA supports this request because the reasonable diversification of FNMA's assets is an important element in FNMA's ability to continue to serve homebuyers, as FNMA was chartered to do. Diversified assets powers have been extended by Congress to savings and loan associations, which have been the primary source of capital for homeownership, and similar ability should be provided to FNMA to meet the shifting demands of the economic cycle.

The proposal to expand the asset powers of FNMA is restricted both by a percentage of total purchases and by the nature of the mortgages eligible for purchase to those related to residential needs. The ability to invest in residential real estate-related financing will not only help FNMA to offset the effects of interest rate cycles in the housing market, but also will allow FNMA to serve as a more complete secondary market instrument for primary lenders.

Other Purchase Authority

In addition to the ability to invest in non-residential loans, several proposals have been made to allow FNMA new purchase and guaranty authority. The removal of loan-to-value restrictions on FNMA multi-family mortgages and the removal of the over-collateralization requirement and term restriction on FNMA loans on the security of mortgages will allow FNMA a healthy flexibility in the fulfillment of its role of serving homebuyers by supporting the secondary market.

Changes in FNMA's Corporate Structure

MBA supports the proposals being made to amend the FNMA corporate structure, and its dependance upon HUD for detailed guidance. Expanding the Board to 18 members, and permitting preferred shareholders to vote will allow new dimensions of expertise, capital, and interests to enrich FNMA's operations. The substitution of HUD oversight and annual reports to Congress in place of prior HUD approval of mortgage programs and FNMA obligations, other than stock and debt convertible to stock, and requiring HUD to respond to FNMA requests within 45 days, will expedite the ability of FNMA to operate in the fast-paced capital and mortgage markets we are experiencing now and can anticipate in the future.

FHLMC Requests for Expanded Authority

FHLMC has requested that it be allowed to purchase loans secured by manufactured housing in states that classify such housing as personal property, to purchase loans secured by junior liens, and to purchase loans insured by state housing finance agencies. These are modest proposals that will enhance FHLMC's ability to support the broad spectrum of the secondary market for mortgages. MBA urges the Subcommittee to give the proposals favorable consideration.

MORTGAGE DEFAULTS, FORECLOSURES, AND DELINQUENCIES

MBA shares the general concern over the problems caused American families by the recent increase in mortgage defaults, delinquencies, and foreclosures. However, we believe the answer to curing these problems is best addressed by full employment and an improved national economy with reduced Federal deficits.

The Nation's economy, in the past two years, has endured the longest, and in many senses the deepest recession since the Great Depression. In the fourth quarter of 1982, unemployment reached 10.8 percent, the highest level since before World War II. Manufacturers used less than 68 percent of industrial capacity. Real Gross National Product, the broadest measure of how our economy performs, was stalled in 1982 at a level below that of 1979. The primary cause of this stagnation was a more restrictive monetary policy pursued by the Federal Reserve Board in order to reduce a prolonged inflationary spiral and to offset mushrooming Federal deficits. At a tremendous cost, this strategy has brought inflation down to its lowest level in over 10 years.

As in other recessionary periods, characterized by prolonged high unemployment, the Nation experienced a higher than normal incidence of mortgage delinquencies and foreclosures in 1982. In the latest non-recessionary year, 1979, for example, the average mortgage delinquency rate, as measured by MBA's National Delinquency Survey, was 4.62 percent, with most of these loans only 30 days delinquent. In 1982, however, the average mortgage delinquency rate was 5.52 percent, a considerable increase. We estimate that this delinquency rate represents about 1.2 million mortgage loans. Again, more than two-thirds of the delinquent loans were only 30 days late, the category that accounted for more than half of the increase in delinquencies during the past three years. Loans that are 90 days or more overdue are those that are most likely to fall into foreclosure. Here, too, there have been increases since 1979—from 0.48 percent of the loans surveyed in that year to 0.76 percent of the survey sample in 1982. Similarly, foreclosure rates also grew during this recession. In 1979, the average rate of loans newly being placed into foreclosure was 0.14 percent. In 1982, an average 0.21 percent of all loans were placed in a foreclosure category. The number of loans in the foreclosure process also grew during this period. This measure includes loans in some stage of foreclosure proceedings, regardless of when those proceedings were begun. During 1979, this inventory number stood at 0.29 percent. In 1982, this measure had grown to an average 0.59 percent.

These statistics demonstrate that, during the recent recession, mortgage delinquencies and foreclosures grew steadily. This is not surprising. Mortgage loan delinquencies are highly correlated with the incidence of unemployment and with family difficulties such as divorce or long illness, difficulties that are also frequently linked to unemployment problems. Unemployment peaked in December, 1982, just four months ago, at 10.8 percent, and many of these unemployed persons had been out of work for some time. We know from studies of the subject that long-term unemployment can lead to increased chances of illness and of family disruptions. It is not unexpected, therefore, that this economic distress should manifest itself in high mortgage delinquency rates and in some increases in mortgage foreclosures. Further, the increase in workers cut back on overtime wages and those working less than full time also contributed to the escalation in mortgage delinquencies and foreclosures, as well as growing problems with consumer loans other than mortgages.

Economic Recovery

Despite the depth of the recession, there are many signs that the worst is over. The number of housing units started, a key indicator of construction activity, was at 321,000 during the first quarter of 1983, compared with 176,700 units started during the first quarter of 1982. This increase of 82 percent represents the highest first quarter total since 1979. Industrial production rose 1.1 percent in March, nearly as high as the large 1.3 percent jump in January, and new orders for durable goods are increasing. Unemployment peaked at 10.8 percent in December and should decline slowly throughout 1983. Inventory liquidations by businesses, a chief contributor to the declines in GNP recorded in 1982, appear to be ending. These and other leading indicators are giving signs that a recovery has begun. Indeed, 1983 should be the best year for our economy since 1979.

Based upon this evidence, MBA believes that national delinquency and foreclosure rates will not become significantly worse during the current economic cycle. Higher employment, as well as the rising real incomes that are typically associated with a slowdown in inflation, should ease the pressure on homeowners and consumers considerably. In addition, if a home must be sold, the current housing market is far more congenial to quick and profitable sale by the borrower than the depressed market of one year ago. Moreover, the substantial decline in mortgage interest rates from late 1981 to the present, a decline that accelerated in the fall of 1982, has created excellent opportunities for refinancing mortgages. Our best estimate is that refinancings account for between 20 to 30 percent of mortgage activity recently, and the lower rate mortgages that are resulting will further ease the affordability problems plaguing many borrowers.

Forebearance

It is also important to point out that despite the increase in delinquencies, our members, as well as the other major mortgage loan servicers, are doing everything that they can to prevent foreclosures. Recognizing the unprecedented severity and extended duration of the recession, mortgage lenders truly are exercising voluntary forebearance and are counseling and working with delinquent homeowners in order to keep them in their homes, while at the same time ensuring that contractual obligations to mortgage investors are preserved.

For a variety of reasons, no reputable lender wants to take back a property. Foreclosures create bad publicity in the community, are administratively costly, and frequently require substantial investment by lenders in securing properties prior to sale or transfer to an insurer or guarantor, such as VA. Not only is foreclosure costly, but, in the case where mortgage bankers are forced to foreclose on a loan, future servicing fees—the bread and butter income for a mortgage banking operation—are lost.

Ironically, the fact that lenders are forebearing results in an increase in the delinquency statistics, because loans are being held in delinquency status for longer time periods, as lenders attempt to continue working with responsible borrowers rather than completing the foreclosure. A factor leading to an increase in the inventory of loans in the process of foreclosure is the rise in personal bankruptcy filings, the effect of which is to impose an automatic stay on foreclosure proceedings. In this light, the higher foreclosures in process do not necessarily represent a worsening of the problem. Also, it should be pointed out that some portion of the loans currently delinquent and in the process of foreclosure are mortgages on investment properties, rather than owner-occupied properties. Unfortunately, it is not possible to separate investment versus owner-occupied properties in the available statistics. This does suggest, however, that not every mortgage problem represents a threat to a family's ability to retain its shelter.

Historical experience has shown that the best medicine for delinquent mortgage payments is a strong economy. A primary factor in ensuring long lasting economic recovery is a determined effort on the part of Congress and the Administration to reduce the massive budget deficits that now hang over us. Federal deficit financing of the kind projected for 1984 through 1988 in the proposed FY 1984 Budget is the chief threat to the kind of sustained economic growth that is necessary to allieviate unemployment, increase incomes, and ease consumer debt burdens generally. Treasury borrowing required to pay for these deficits crowds out private borrowers in the capital markets and puts upward pressure on interest rates. The last thing that America needs is a repeat of the 1980-1981 experience when rising interest rates choked off an incipient economic recovery. We strongly urge the Congress to tackle the difficult problems of the Federal deficit and to reduce future deficits significantly.

"UNEMPLOYED HOMEOWNERS RELIEF ACT OF 1983"

MBA has testified this year before several Congressional committees on various legislative proposals aimed at assisting families facing problems in connection with their mortgage payments. As we will today, we have expressed concern that such assistance may not be necessary because of the improvement in the Nation's general economic health. However, in the event Congress does enact such legislation, we wish to assist in the development of a workable and efficient program, and we offer the following observations with this intention in mind.

Title VII of the Senate Banking Committee's version of the 1983 housing bill is the "Unemployed Homeowners' Relief Act of 1983" (the Act). The Act would authorize the Secretary of the Department of Housing and Urban Development (the Secretary) acting through the Government National Mortgage Association (GNMA) to guarantee the timely payment of principal and interest on loans secured by junior mortgages made by private lenders to assist homeowners in avoiding foreclosures of existing first mortgages. The Secretary's guaranties may not exceed $750 million at any time, and the authority terminates on October 1, 1985. No funding authorization is made to cover payments of claims on the guaranty, but authority is provided for the Secretary to impose a fee of up to one percent for any guaranty issued.

The amount of any particular guaranty may be as great as the amount due on the homeowner's delinquent first mortgage during the three-month period prior to the date the assistance loan is made, plus 95 percent of the monthly payments, which will be due 24 months after the date of the assistance loan, plus an amount equal to the interest that will accrue on the assistance loan up to the date the homeowner's repayment obligation commences on the assisted loan. The Security may determine the interest rate on the assistance loan.

The guaranty shall be for 100 percent of the assisted loan's principal and interest as to investors who purchase the assisted mortgage loan, but the lender making the assisted loan must bear the first 10 percent of any loss on the assisted loan. Furthermore, the lender making the assisted loan must deposit the loan proceeds in an escrow account, from which the assistance payments will be drawn, and must pay interest on the escrow account at a rate determined by the Secretary.

In order to be eligible for assistance, a homeowner must have suffered a substantial reduction in income because of involuntary unemployment or underemployment due to adverse economic conditions; be unable to make full monthly mortgage payments; be threatened with foreclosure; have previously maintained good mortgage payment practices; and have a reasonable prospect of fully resuming payments on the mortgage. Homeowners with delinquent mortgages insured under the National Housing Act or assisted under Title 5 of the Housing Act of 1949, or with mortgages, the original principal balance of which exceed the principal balance that could be insured, at the time the assistance application is made, under Section 203 (b) and (n), or 234 (c) of the National Housing Act are not eligible for assistance under the Act.

The Act explicitly directs that the Secretary's guaranty shall be provided upon certification, by a lender approved by the Secretary for the purposes of making any mortgage home loan under the National Housing Act, that the loan conforms to the requirements of the Act, that the mortgagor is eligible, and that the lender has provided appropriate credit counseling to the mortgagor.

MBA COMMENTS

Eligibility

Economic Circumstances. MBA's major concern regarding foreclosure relief is its potential cost. In this light, we note favorably that the proposed relief program is limited in nature, applying only to the principal residence of a homeowner who is unemployed or underemployed due to economic circumstances. MBA does not believe that a foreclosure relief program should be extended to cover marital breakups, illnesses, and other types of problems not arising out of the temporary economic recession. It is a pragmatic reality that a relief program will be limited, and thus, should be targeted to those most in need due to the extraordinary circumstance of today's high level of unemployment.

Regional Economic Triggers. To limit overall cost, MBA supports the concept included in the Act that the relief program should be a temporary one, in existence only to the extent justified by temporary economic conditions. However, in addition to the October 1, 1985 sunset provision, the program should be triggered on a regional basis because recent foreclosures have been concentrated in regions experiencing high unemployment. MBA recommends a trigger based on local or regional unemployment statistics so that the program can be focused to address the underlying cause of the upturn in delinquencies. Furthermore, any trigger that is used to turn the program on should have an automatic cutoff as well, so that once unemployment slides below the trigger level, the program will automatically deactivate. Of course, those borrowers who have already been accepted for relief under the program should continue to be served until their eligibility period expires.

Second Mortgages. Although the eligibility section of the Act, Section 703, does not expressly limit assistance to delinquent first mortgages, the section requires that, for eligibility, a "second mortgage" must be executed by the relief recipient. This implication that only delinquencies on first mortgages may be assisted is confirmed in section 704, which establishes that the amount of relief is measured by the size of the payments due under the first mortgage. A significant number of homeowners lose their home by foreclosure of a second mortgage, even though the first mortgage holder is willing to forebear. If the Act is to provide protection for all homeowners temporarily affected by the economy, consideration should be given to including unemployed homeowners with delinquent second mortgages.

FHA Insured Mortgages. The exclusion of homeowners with FHA insured mortgages from assistance under the Act is presumably in recognition of the enactment in 1980 of a program of relief for FHA insured homeowners, the Temporary Mortgage Assistance Payments (TMAP) program. However, a Federal District Court in Chicago has enjoined HUD from implementing the TMAP program and the Subcommittee may wish to take this injunction into account.

Ability to Repay. The Act should require that a determination be made that the recipient of assistance has a reasonable chance of making repayment of the assistance loan. To do otherwise is simply to avoid the inevitable and stall foreclosure until a later date with little possibility to recoup the assistance.

Extent of Relief

Partial Payments. MBA agrees with the provisions of the Act that the relief program should only supplement a borrower's limited ability to pay, by requiring a mortgagor to make partial payments to the extent the mortgagor is capable. Partial payments not only reduce the cost of the program, but also indicate a borrower's ability and willingness to work out delinquency problems. Even if the partial payment is nominal, lenders practicing forebearance with borrowers have found that partial payments are a good indication of a borrower's continued interest in solving the delinquency. However, the partial payment requirement should be flexible enough not to bar the otherwise deserving homeowner who has no available resource to contribute. The rigid 5 percent minimum required in the Act impedes this flexibility.

Repayment with Interest. The requirement of repayment, with interest, secured by a junior lien, which the Act imposes on assistance, also will reduce the incentive for borrowers to rely on the program, when they otherwise may be able to work out problems through counseling or a forebearance plan. Such an interest charge is not intended to penalize a delinquent borrower, so much as to increase the incentive to solve the delinquency by private means, rather than simply resorting to what essentially would be an interest-free Federal grant. If assets are available, they should be sold by a borrower to reduce the credit load. A borrower who can rely on an interest free loan to keep up mortgage payments has little incentive to sell assets or resume payments to retain his or her home.

Length of Assistance Period. MBA believes that the 24 month base period provided by the Act for assistance is too long, and further that, regardless of the monthly payments allowed to be covered, the total assistance should not exceed the borrower's equity in the home. MBA suggests that assistance payments should be limited to 6 months, with 6 month extensions up to the total of 24 months. In most cases, to go much beyond six months severely reduces the ability of a borrower ever to repay the assistance and to bring the mortgage current. Most foreclosures occur within the first several years of a mortgage, when there may be little equity built up in the home, particularly where the downpayment was small. In such cases, the likelihood is that the borrower, faced with repayments which exceed his or her equity in the home, will default and simply walk away. With a lack of equity invested in a home, it is better for the borrower to resolve the situation in the present, and seek lower cost housing.

Miscellaneous

Inclusion of All Charges. The Act should be amended to clarify that assistance payments should cover lenders' expenses in connection with payments or repayments, late charges, and other charges necessary to bring mortgages current. Also, the Act's provision that assistance would cover only three monthly payments prior to the assistance loan being made should be changed so that all payments due on the date the assistance loan is made would be included in order to encourage maximum forebearance by lenders. If only three monthly payments are to be covered, lenders will be discouraged from any forbearance of more than three months, and will be induced to begin foreclosure proceedings after 90 days, which is the minimum time allowed now under current practice.

Counseling. MBA concurs with the Act that lenders or other parties should counsel borrowers during this period because such counseling can itself be a form of relief. Also, lenders should conduct periodic reviews to determine whether the circumstances of the borrowers have changed, either positively so that the borrower no longer needs assistance, or negatively, such that further assistance would be wasted because the borrower has little chance of regaining solvency. There should be penalties imposed for fraudulent misrepresentations by a borrower concerning present employment or assets, either at the application or periodic review stage.

Non-FHA Approved Lenders. The types of lenders who may make a certification under section 705 of the Act should be expanded beyond those who are HUD-approved mortgagees. Almost all mortgage bankers involved in lending on the security of single-family mortgages are HUD approved mortgagees, but some supervised depository institutions are not, even though they could be, because they have never applied for approval. The Subcommittee may wish to consider granting certification authority to all federally related mortgage lenders, as that term is defined in the real estate mortgage usury preemption, Title V of the Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221).

GNMA. The Secretary should not be directed to operate the assistance loan guaranty program through GNMA. GNMA is a small constituent part of HUD with 56 employees. It has no regional or local offices. Its guaranty experience has been that of a secondary guarantor, perfecting the initial and basic endorsement of the FHA or VA. The Act would seem to overcome the lack of processing capacity of GNMA by providing, in section 705, that the Secretary's guaranty shall be provided (emphasis suggested) upon adequate certification by lenders that the Act's conditions of guaranty have been met. But the Act provides no penalities for an inaccurate certification, whether the inaccuracy be accidental, judgmental, or intentional. Other agencies of the Government, including FHA, have developed programs that rely on lender investigation, underwriting, and certification, but GNMA has not.

Recognition should be given that HUD will need additional personnel to operate the program, wherever it is placed within HUD. Recognition should also be given to the fact that GNMA, and other HUD offices which provide backing for mortgages, are subject to Congressionally set credit budget limits in their guaranty and insurance authority. If the relief program is enacted, provision should be made for additional personnel and higher guaranty ceilings.

Guaranty Fee. While MBA recognizes that user-fees are a beneficial element of Government programs in support of home ownership, as in the unsubsidized FHA and GNMA programs, the expectation of funding the Act's relief program through a one percent guaranty fee may be inappropriate. Section 708, which authorizes the Secretary to impose a fee of one percent for the guaranty, does not indicate how the fee should be imposed. Because most eligible borrowers will have no funds with which to pay the fee in cash, and because lenders are being asked to absorb, and perhaps increase, the risk they already have, the most reasonable technique for collection of the guarantee fee would be to include it as part of the assisted loan. If this is the intent of the Act, Section 704 should be amended to include the guaranty fee in calculating the amount of the guaranty. Whether repayment of assistance loans generally will be adequate to make the guaranty program actuarially sound will depend on the underwriting applied to the program. Because this cannot be known in advance, Congress should be mindful that future appropriations may be necessary to fund the guaranties made pursuant to the program authorized by the Act.

Program Effectiveness. Finally, and perhaps most importantly, MBA has serious reservations that the program set forth in the Act will not adequately provide relief from foreclosure in the event Congress finds that such relief is needed. The 100 percent guaranty to buyers of assistance loans will encourage a secondary market, and, if enough of these loans are made and sold, the secondary market could adjust to the low interest rates that the Secretary will likely set, and the initial two year priod of no principal repayment, which the loans will have. But the requirement that the lender making the loan absorb the first 10 percent of loss, effectively limits the original source of these loans to the lender holding the delinquent mortgage needing assistance. No other lender is likely to make a 90 percent guaranteed loan to a borrower who is unemployed and delinquent in payment of major debt.

The consequences of creating a 10 percent fixed-risk-share program to encourage the lenders holding mortgages of homeowners needing assistance to advance that assistance is uncertain. Various lenders will evaluate this risk differently. Lenders who are capital-short or with negative income will be inclined to avoid further risk. One result will be that borrowers from lenders in certain circumstances will receive assistance while others, equally deserving, will not. Another result will be that, to the extent that lenders in general perceive the 10 percent risk to be less than they would have, if they did not participate in the program, they will use the program widely to shift the risk to the Secretary; to the extent lenders see the risk as more than they now have, they will not participate in the program, depriving homeowners of its benefits.

Summary

In closing, MBA believes that the fundamental problem is one of unemployment, particularly structural unemployment in industries that may never recover from the present recession. Stabilizing interest rates to spur industrial output and reemployment of those out of work will do far more good than a temporary assistance program that does not address the underlying problem. While the cost of a foreclosure program is insignificant compared with the entire Federal budget, it is just such incremental additions that bloat the total Federal deficit. We believe that with the peak in the unemployment figures passing,. and the recovery in the housing market already well underway, delinquencies and foreclosures will also trend down. Also, if Congress enacts a jobs program, reemploying many of those currently out of work, this will reduce mortgage delinquencies, thus reducing the specific need for foreclosure relief. If Congress decides to enact a foreclosure relief program, it should attempt to target the program to those who will benefit the most, and with the assistance, get back on track and resolve their mortgage delinquency situation. Our suggestions that are incorporated in this testimony attempt to target the framework of an assistance program to those who can regain their financial footing in the future.

MBA appreciates the opportunity to appear before the Subcommittee today and would be happy to furnish any additional information if needed.

Senator HEINZ. Thank you very much, Mr. Beck.

There is one question, and one only, that I want to address to Mr. Kendall, because there's a budget resolution on the floor, and the legislation is independent of what you have all been testifying on.

This has to do with mortgage foreclosure legislation, Mr. Kendall, which is an object of discussion which the next panel will testify to.

INSURANCE FEE FOR MORTGAGE CREDIT FAILURES

My question is a limited one. In the legislation, there is an expectation that GNMA will charge roughly a 1-percent fee to insure itself against the costs of any mortgage credit failure that it would be party to insuring against.

My question to you, do you think that fee is roughly in the ball park, judged by your own experience?

Mr. KENDALL. What we have is Ginnie Mae trying to protect itself against losses on loans that are already in trouble.

Senator HEINZ. On guarantees made under the legislation?

Mr. KENDALL. A one-time, 1-percent fee.

It's exposure, as I understand it, is not the whole mortgage, but the added payments that are made to support the mortgage during that interval.

Senator **Heinz**. That is correct.

Also, there are certain criteria that the thrifts and other depository institutions, the people issuing the mortgages, are using to decide whether or not that so-called second loan will be made.

Mr. **Kendall**. Senator, does the charge apply to the whole loan or to the advances in the sense that, let's say, we have a $50,000 loan and we advance $5,000.

Senator **Heinz**. To the entire second lien.

Mr. **Kendall**. To the second lien.

I would like to ask my actuaries to look at that. My first impression is that if that is the base it probably is low. If the base were the whole loan, then I think you could get pretty close.

It is 1 percent per year.

Mr. **Kendall**. It's not a one-time 1 percent, it's 1 percent a year?

Senator **Heinz**. That's right.

Mr. **Kendall**. What I would like to do, since we have a healthy amount of experience in this area, is to come back to you with the views of some actuaries, for my answer.

Senator **Heinz**. Thank you very much.

Mr. **Beck**. I'd like to make just one comment on that. I'm trying to figure out where that money is coming from, who's going to pay it. Probably it's something that's going to be added to the loan because nobody could come up with the cash. Is that the idea?

Senator **Heinz**. That's correct.

It's essentially an insurance fee that's a part of the principal amount.

Very well. Gentlemen, thank you very much.

Our next set of witnesses will testify as to mortgage assistance, Mr. Paul Prior, vice chairman of the U.S. League of Savings Associations; Ms. Susan Wachter from the Wharton School of Finance of the University of Pennsylvania—she will submit her testimony in writing; Mr. Lawrence Swanson, accompanied by Mr. Sam Rockwell, representing Action Housing in Pittsburgh and Dollar Savings Bank; and Mr. Henry Schechter of the AFL-CIO.

I want to thank our witnesses for being like our last panel, extremely patient. I hope our witnesses will submit their entire remarks for the record, restrain their enthusiastic testimony, and limit it to 5 minutes, so there will be an opportunity to ask some questions.

I'd like to ask Mr. Prior to please be the leadoff witness.

STATEMENT OF PAUL W. PRIOR, VICE CHAIRMAN, U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Mr. **Prior**. Thank you, Senator.

My name is Paul W. Prior. I'm chairman of the board and president of the Henry County Savings and Loan Association of New Castle, Ind. We are a $200-million financial institution located in rural, east-central Indiana.

And I should like to say to Mr. Davis of the National Association of Realtors, who preceded me, that his report of the demise of the savings and loan business in housing lending is vastly premature. We are very active.

I'm also amazed at the emphasis today on the secondary market as the only source of mortgage credit, because there is a great and active direct market in real estate lending in the savings and loan business. We've always been part of it and will be there when the roll is called up yonder, or whenever.

Our primary function has been the financing of single-family-occupied housing. Our typical borrowers are middle-aged parents and assembly line workers residing in a $30,000 to $40,000 home, with a gross annual household income of about $20,000.

The majority of jobs in our lending area are provided by the automotive industry. Our lending area has been devastated by unemployment during this latest recession. The percentage of unemployed has risen from less than 7 percent in 1978 to over 17 percent today, and has recently been as high as 22 to 23 percent. This employment-unemployment cycle has been repeated several times during the past 20 years. As a result, our institution has developed policies to cope with the effects of unemployment on the communities we serve.

SPECIAL CONSIDERATION TO THE UNEMPLOYED

We give special consideration to those who are unemployed due to circumstances beyond their control, such as layoffs, factory closings, and so forth. The borrower who respects his obligation and his property, and demonstrates a willingness to help himself, can remain in his home until there is no other alternative. Provided there is a likelihood for recovery, borrowers have been permitted to remit little or no payment for an extended period—indeed, many times, in excess of 2 years.

We have routinely advanced funds for the payment of real estate taxes and homeowner's insurance. Each individual situation is continually monitored during the period of any delinquency.

To give you a comparison between a healthy economic situation and a recessionary one, we have analyzed our overall delinquency and foreclosure activity for calendar years 1978 and 1982.

May I direct your attention to the chart on page 4 of my written testimony.

In 1978, a robust year for employment, we initiated foreclosure action against eight borrowers. Of those, four of the properties were abandoned prior to initiation. In only one was the cause attributable to unemployment.

By comparison, of the 22 actions taken in 1982, 16 were preceded by abandonment. Eight of the 22 borrowers were unemployed, but in each case they previously had abandoned the property, leaving us no alternative.

Thus, although our mortgage delinquency ratio has skyrocketed more than sixfold during our present recessionary period, the percent of delinquencies resulting in action is less than half the percentage found in 1978. We believe this demonstrates how we have responded to the plight of the unemployed in the communities we serve.

Mr. Chairman, we have also examined the legislative responses to the problem of rising mortgage delinquencies now pending in the House and here in the Senate. We find title VII of S. 644, recently reported by your distinguished committee and developed, I am told, by you and Senator Riegle, far preferable to the approach being debated this afternoon, I understand, on the floor of the House.

Your program does not involve appropriated funds, relies upon lenders for basic program administration, has more refined eligibility standards, and encourages unemployed borrowers to continue to meet some portion of the payments on their first mortgages. The instruction to the agencies to recognize forbearance efforts at the institutions they supervise is a worthwhile portion of your bill.

We recognize, of course, that a Ginnie Mae-guaranteed second mortgage is an untried concept. Whether or not such loans are indeed marketable as a means of liquefying the asset remains to be seen. In any event, we wish you well if a conference is eventually necessary to reconcile your title VII with H.R. 1983, as it now stands in the House.

My prepared testimony goes on to address various legislative requests of the secondary market agencies as well.

In conclusion, Mr. Chairman, I wish to commend you and this distinguished committee for your work in reviewing the Nation's housing program and your efforts to address the problems of mortgage delinquencies in a responsible way.

I am honored to present this testimony and invite your questions.

[The complete statement follows:]

STATEMENT OF PAUL PRIOR
To the Senate Committee on Banking, Housing and Urban Affairs

May 5, 1983

MR. CHAIRMAN:

My name is Paul W. Prior. I am Chairman of the Board and President of Henry County Savings and Loan Association of New Castle, Indiana, and appear today in my capacity as Vice Chairman of the U.S. League of Savings Institutions. I am accompanied by William T. Wallis, President of First Federal Savings and Loan Association of Martin County, Florida.

I am pleased to participate in today's hearing. I hope that my years of experience as the chief executive officer of a savings and loan association may be of some benefit as this distinguished Committee assesses the mortgage foreclosure situation nationwide and explores possible responses by the Federal Government. Mr. Wallis chairs our League's Advisory Committee on the activities of the secondary market agencies and is available today to respond to questions you might have on the League's positions relative to their pending legislative requests.

A "TYPICAL" SAVINGS INSTITUTION'S EXPERIENCES WITH FORECLOSURES

Henry County Savings and Loan Association is a $210 million financial institution located in rural east central Indiana. Our principal office is located in New Castle, a community of approximately 20,000 people, situated 40 miles northeast of Indianapolis. We maintain four branch offices in three separate localities.

Our primary function historically has been the financing of single-family owner-occupied housing, though we offer various other lending services. Our typical borrowers are middle-aged parents and assembly-line workers residing in a $30,000 to $40,000 home, with a gross annual household income of about $20,000.

Our delineated lending area encompasses nine counties with a populace of a half million people employing a labor force just in excess of 200,000.

The majority of these jobs are provided by industry, with the automotive and its related fields employing the bulk of the labor force. Considering our reliance upon that industry, it will come as no surprise that our lending area has been devastated by unemployment during this latest recession. The percentage of unemployed has risen from less than 7% in 1978 to over 17% in 1983, and has remained constant throughout the past two years. During this time, certain areas have endured a rate in excess of 21%. Recessionary problems are nothing new to our area. This employment/unemployment cycle has been repeated several times during the past twenty years. As a result, our institution has developed policies designed to cope with the effects of unemployment on the communities we serve. Realizing that the protection of our depositors must be a foremost concern, we have developed our collection process with the overall welfare of our communities in mind.

Although our philosophy has always been one of leniency in relation to financially-strapped borrowers, we have given special consideration to those unemployed due to circumstances beyond their control, i.e., lay-offs, factory closings, etc. (You may find of interest the "Slow Loan Policy" adopted formally by our Board of Directors in February, 1975, a copy of which is attached and marked "Exhibit A".)

This "Slow Loan Policy", formulated for economic situations such as the present, details our attempts to keep every borrower in his home until he "chooses" an alternate course. The borrower who respects his obligation and his property, and demonstrates a willingness to help himself, can remain in his home until there is no other alternative, provided there is a likelihood for recovery. In cases such as these, borrowers have been permitted to remit little or no payment for an extended period, sometimes as long as two years. We have also routinely advanced funds on behalf of the borrower for the payment of real estate taxes and homeowner's insurance. Each individual situation is continually monitored to ascertain any change in circumstances that would affect the ability to maintain the property.

This philosophy which guides us in a period such as the present is considerably more relaxed than our normal collection procedures, outlined in our "Policy and Procedure for Handling Past Due Accounts", marked "Exhibit B". When operating in a normal economy, we consider any loan more than three months in arrears to be critical and subject to legal action, unless a satisfactrory repayment plan can be established and implemented.

To give you a comparison between a healthy economic situation and a recessionary one, we have analyzed our overall deliquency and foreclosure activity for calender years 1978 and 1982. To simplify this analysis we have calculated and averaged the figures peritnent to our monthly delinquency ratio, and present this for comparative purposes only.

The year 1978 was a period of robust employment and economic boom for the nation and certainly for Indiana. As indicated in the analysis, we initiated foreclosure action against eight borrowers during this period; of those, four of the properties were abandoned by the borrower prior to initiation. In only one instance was the cause attributable to unemployment, and that foreclosure was dictated by abandonment, rather than inability to pay.

In comparison, of the 22 actions taken in 1982, sixteen were preceded by abandonment. Eight of the twenty-two borrowers were unemployed at the time of action, but in each case, they previously had abandoned the property leaving us no alternative. In the six cases where abandonment was not a factor, income was ongoing, but for various reasons the borrowers were unwilling to pay.

Thus, although our mortgage delinquency ratio has skyrocketed more than six-fold during our present recessionary period, the percent of delinquencies resulting in action is

DELINQUENT ACCOUNTS	1978	1982
Number of home loans serviced	9100	9400
Number of loans 60 days or more delinquent (monthly average)	31	188
Percentage of delinquent loans to all loans serviced	.34%	2.00%
Number of loans 90 days or more delinquent	.7%	1.55%
Percentage of loans over 90 days delinquent	.08%	1.65%

FORECLOSURE ACTIVITY	1978	1982
Actions* initiated	8	22
Percent of delinquencies resulting in action	25.8%	11.7%
Average delinquency at time of action (months)	8	13.5
Number of properties abandoned prior to action	4	16

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*"Action" consists of either a suit to foreclose, or a deed in lieu of foreclosure (a procedure whereby the lender accepts a voluntary conveyance of title to the property in complete

We believe this demonstrates how, in responding to the plight of the unemployed, we have been ever mindful of the overall welfare of our community.

Foreclosure, from our perspective, is a "last resort" to preserve the security property. It is an expensive process, involving court costs, payment of back taxes, and often maintenance and repair. Furthermore, once the property is reclaimed, it is difficult to dispose of in today's market -- particularly, as I mentioned, in a community with 17 percent unemployment. We do not want to be in the property-management business.

As this Committee is aware, the foreclosure process varies dramatically from state to state. Although our local procedure is not vital to the subject at hand, we have provided a brief description of the process as governed by Indiana statute. This description is attached and marked "Exhibit C".

I have read about delinquency and foreclosure figures nationally, and our experience does not seem out of line with national norms -- despite the severe unemployment picture in the communities we serve.

I would attribute our delinquency ratio and our ability to hold down foreclosures to several factors. I believe we were careful in underwriting our borrowers in the first place. As a rule, our loans are "conventional", rather than FHA or VA. Conventional loans usually involve larger downpayments -- thus a greater initial equity commitment on the part of the homebuyer -- than is found typically in the government-backed loan programs. In addition, our market in Central Indiana did not experience the speculative real estate "craze" we heard about in California and elsewhere in he late'70s -- with homebuyers pyramiding second and third liens, and widespread "creative" financings.

UNEMPLOYED HOMEOWNERS RELIEF ACT

In respose to the problems faced by mortgagors and mortgagees, two major legislative proposals have emerged in this 98th Congress: the Emergency Housing Assistance Act, H.R. 1983, which I understand will be debated this very afternoon in the House of Representatives, and the Unemployed Homeowners Relief Act, Title VII of S.644, the omnibus housing bill recently approved by this distinguished Senate Committee.

From the perspective of the U.S. League, your program is far preferable to the alternative which is being debated on the House floor. Senators Heinz and Riegle of this distinguished Committee are to be complimented for their efforts in developing a more effective assistance program.

But, before discussing this subject in greater detail, I would like to make this point: I would hope that the Congress would deal with the underlying causes of the problems which manifest themselves as rising home mortgage delinquencies.

A reduced federal deficit through sound fiscal policies, a return to reasonable interest rates, and new job opportunities should, in my opinion, be fundamental objectives of this 98th Congress. When those are satisfactorily addressed the problems with missed mortgage payments will diminish to more normal levels.

At its annual Legislative Conference in March, our League adopted a list of standards we feel are appropriate for any national approach to mortgage delinquencies. Any such legislation should: recognize and encourage the forbearance efforts of private financial institutions; be temporary in duration; be restricted to owner-occupied homes; involve repayable assistance; be administered by lending institutions; permit lenders to assess prior payment records of applicants for assistance; and be targetted carefully to those borrowers unable to meet their full payment due to unemployment occurring within a fixed time period.

I am encouraged that Title VII of S. 644 meets these standards quite well. Your eligibility section, for example, permits lenders to assess prior payment experience and is limited to mortgagors experiencing involuntary unemployment. Your program is of limited duration -- expiring on October 1, 1985. (Indeed, we would suggest -- if the economy improves -- a mid-program review by the Congress next year to determine whether its continuation is justified.) The assistance is repayable. Basic administration remains with the lender, which originates the second mortgage (covering 3 months of delinquent payments and 24 months of payments on principal, interest, hazard insurance and taxes) and presumably handles the escrow or trust account. Section 707 of your bill calls upon the financial regulatory agencies, consistent with their responsibilities regarding safety and soundness, to take the supervisory steps which will encourage lender forbearance efforts. The requirement that homeowners continue to pay at least 5% of their monthly payment during the assistance period is a helpful provision.

Our reservations, such as they are, stem largely from years of frustration in dealing with the Department of Housing and Urban Development. (The experience with the assignment program presently in place for FHA home loans has been less than satisfactory.) While we appreciate that there is no directly administered rate for the second mortgages created under this program, the Secretary still has authority to determine that the rates charged are not "excessive". As explained earlier in my testimony, there are compelling reasons for home lenders with delinquent borrowers to make every effort to help their customers work their way out of their financial difficulties. It would be counterproductive to charge exorbitant, above-market rates under this GNMA-guaranteed second mortgage program. Similarly, we would hope that any rules promulgated by HUD would give maximum recognition to the lender's, familiarity with the borrower, including those implementing the certification called for in Section 705.

We all recognize, of course, that a Ginnie Mae-guaranteed second mortgage is an untried concept; whether or not such loans are indeed marketable, permitting the lender to liquify its asset, remains to be seen. Furthermore, we would hope that the guarantee could be accomplished for less than the one percent fee permitted by Section 708.

The U.S. League does not object to the 90/10 "coinsurance" feature of this plan. (We have previously supported such a concept in the now largely-dormant Farmers Home-guaranteed housing loan program.) Retention of some risk of loss by the lending institution limits the exposure of the Government while encouraging careful loan underwriting by the lender.

As we indicated, we have far more questions about the Emergency Housing Assistance Act (H.R. 1983) under consideration in the House of Representatives. First of all, we are concerned about the "cost-benefit" implications for a $760 million program using direct appropriations. The plan also involves elaborate application requirements, some of which run roughshod over State laws, contractual obligations and legal remedies available to lenders on their security property. For example, loans already in foreclosure are automatically stayed if an application for HUD assistance is filed, and lenders must plead compliance with notification and application-preparation requirements as a precondition to proceeding with legal remedies on foreclosed properties. Furthermore, the interest rate HUD may charge on the repayable assistance is strictly limited.

SECONDARY MARKET LEGISLATIVE REQUESTS

The subject matter of today's hearing also includes the legislative requests of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Although those items, to our knowledge, have not been introduced formally in the Senate, nor are specific legislative proposals included in S.644 reported by your Committee two weeks ago, we have a general understanding of the changes desired by the two federally-sponsored secondary market agencies. Our Executive Committee reviewed their requests for legislative change on April 24 and, as mentioned above, Mr. William Wallis, Chairman of our Advisory Committee on FNMA/FHLMC/GNMA, appears with me today to answer any questions you might have about our U.S. League positions.

Fannie Mae and Freddie Mac have traditionally provided lenders with liquidity and helped to redistribute funds from areas of capital surplus to those of capital shortage. They have also pioneered in the use of standardized documentation.

The FHLMC was chartered as a result of the experience in the credit crunches of 1966 and 1969, and the role of FNMA was redefined at that time. These agencies have been particularly useful during more recent periods of housing credit shortage -- developing such innovative programs as the "swaps" of lower-yielding loans for more-marketable FNMA- and FHLMC-packaged securities.

And this Committee took the lead last year in strengthening the capital bases of FNMA and FHLMC through authority for preferred stock issuances, though we would remind the Committee that a solution has yet to be developed for replacing the initial $100 million capitalization of the FHLMC in 1971 by the Federal Home Loan Bank System (and its savings institution stockholders) now that that Corporation is available without distinction to institutional sellers generally. (Current value of the initial $100 million is now several times larger.)

One major legislative objective of both agencies, which our organization supports wholeheartedly, is relief from the statutory limits placed on loans available for purchase (currently $108,300). There is wide variance in the mortgage amounts available for purchase in different markets across the nation. Historically, the average loan purchased has been well below the statutory ceiling; yet, certain high-cost areas generate loans well above the current $108,300 limit because of the homes for sale in those localities.

FNMA and FHLMC could serve the total market far more efficiently if the ceilings were removed or raised significantly. In the mortgage marketplace, inevitably a certain premium is attached to those higher-dollar loans which are not available for sale because of the statutory barrier imposed on the agencies. If an adjustment is made, we would recommend complete removal or an increased ceiling, rather than creation of a "basket" for higher-cost loan purchases (based on prior-year purchase activity). (Federally-chartered savings institutions lived for years with a "basket" approach to various asset categories and, we found it an awkward method of credit allocation.)

Another objective announced by the Federal National Mortgage Association, and presumably available to the FHLMC as a matter of parity, is specific statutory authority to guarantee mortgage-backed securities "issued" by FNMA-approved lenders (rather than just those backed by mortgages purchased by FNMA). The Association currently has guaranteed mortgage-backed securities out in the marketplace and available to regular seller-servicers. That program is satisfactorily serving the housing market, in our view. We are concerned that an expansion at the present time to include securities issued by FNMA-approved lenders could undermine Fannie Mae's existing guarantee program. Therefore, the U.S. League must oppose this request for expanded authority.

Similarly, our League opposes Fannie Mae's request for removal of current restrictions on its ability to offer short-term borrowings to its secondary market users through its ability to make "loans on the security of mortgages". These restrictions limit the term of such borrowings and require over-collateralization for such loans. Direct funding activities by Fannie Mae could divert that agency from its fundamental role as a purchaser of mortgages originated by supervised and FHA-approved lenders. Thus, the U.S. League opposes this request.

The U.S. League sees considerable merit in other FNMA legislative objectives, and supports the following:

#- The request for authority to purchase up to 10 percent of the preceding year's secondary market activity (5 percent in the first year) for non-residential mortgages serving the needs of residents in subdivisions, neighborhoods, housing projects, or other residential areas;

#- The removal of statutory loan-to-value restrictions on FNMA multi-family mortgage purchases;

#- Statutory flexibility for FNMA to offer limited voting rights to holders of preferred stock;

#- Dual responsibility for both FNMA and the HUD Secretary to report annually to Congress on FNMA's activities; such annual reports should substitute for the prior clearance by HUD of new FNMA mortgage programs (as stipulated by existing law);

#- Elimination of statutory language requiring HUD prior clearance before FNMA may issue obligations other than stock and debt-convertible-into-stock;

#- And, statutory direction to HUD to respond to requests by FNMA for action under its charter act within 45 days.

In addition, we support the Federal Home Loan Mortgage Corporation's efforts for statutory change to permit the purchase of loans on the security of manufactured housing (mobile home loans), and authority to buy State-agency-insured (as well as FHA-insured and VA-guaranteed) home mortgages.

Furthermore, we support revision in existing authority for FNMA and the FHLMC to purchase subordinate (second) mortgages in general -- not just those where the proceeds are dedicated to "home improvement" and "energy improvement" purposes. We would suggest that the portion of the request requiring private mortgage insurance coverage for the amount about 80%-of-value be broadened to enable mortgagees to establish a reserve for coverage of such excess. The alternative of using either a reserve or PMI coverage was utilized successfully for many years in the rules governing lending by federally-chartered thrifts investing in low-downpayment home mortgages.

***

CONCLUSION

Mr. Chairman, the U.S. League is impressed by the workmanlike effort that you and this distinguished Committee have devoted to the review of our nation's housing programs, just as we applauded your initiative in addressing the thrift crisis and financial institution modernization in last year's Garn-St Germain Act.

I have been privileged to share with you today the perspective of what I believe is a representative lending institution in dealing with the mortgage payment problems of deserving homeowners faced with a very real economic crisis due to lay-offs and unemployment. Title VII of S. 644 recently reported by your Committee is a realistic approach to the rapid rise in mortgage delinquencies nationally -- and far preferable to the legislation under consideration in the House (H.R. 1983).

Mr. Wallis and I have also appreciated this opportunity to express our views on various legislative requests put forward by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. We support removal of statutory ceilings on the dollar amounts of purchases of home mortgages by these agencies, and permission to buy second mortgages (without current restrictions), mobile home loans, State-agency-insured home loans, and limited authority to acquire non-residential loans tied to certain community purposes. We support, as well, the various requests of Fannie Mae for relief from administrative interference from HUD.

Again, I have been honored to appear before you today and look forward to your questions.

EXHIBIT A

SLOW LOAN POLICY
HENRY COUNTY SAVINGS AND LOAN ASSOCIATION
NEW CASTLE, INDIANA
(Adopted by Board of Directors, February, 1975)

The following slow loan policy is being presented to the Board of Directors for adoption. It has been formulated to empower the officers, and in turn the staff, of our Association with the authority to deal adequately in the area of slow loans during the present economic crisis.

The present rate of unemployment nationwide is approximately 8.2%. It is certain that national unemployment will continue to increase in the near future. Therefore we as a nation may be facing 9% or more unemployment.

In Henry County the unemployment rate was a critical 18.2% at the end of the year--as compared to 3.4% in January 1974. In New Castle the figures are even more startling. As of the same date the city's unemployment rate was 23.9% compared to 4.7% a year ago.

These exceptionally high rates are understandable when we consider our dependence on automotive and related industries. These figures point ot the severity and urgency of immediate direct action in dealing with the situation confronting us.

We are dealing with customers whose circumstances range from one end of the spectrum to the other. We have slow loan problems with borrowers who are fully employed and have had no curtailment in their income and we have customers who, already, are without income. Some of our customers who are without employment are, at the present time, receiving 95% of their base wages. Others are receiving only unemployment compensation.

As we can see in the attached projections from local industries, the outlook for the next 6 months does not promote much optimism. It seems evident that these problems are to remain with us for some time. We must move now to confront the problem and set out the guidelines we will follow as an Association.

Therefore after considerable deliberation we are convinced that the problems we are dealing with are as varied as our customers. We are hard presssed to set down on paper the exact requirements we will expect in each circumstance. We must prepare to deal with each customer individually. We must determine the best avenue for that customer, then through periodic contact, continue to evaluate his circumstances for any change.

In an interview with our customer, we will determine his present financial condition by discussing the following areas: employment of all parties involved, both present and future; sources of income; other sources of funds available; monthly obligations; savings; equity in the property; past record with HCS; and the willingness of the customer to help himself. Undoubtedly, the most important purpose of this interview is to determine the attitude the customer takes toward the problem and the property. Does he want to keep the property? If not, he should immediately place the property for sale at a reasonable price. If he takes this attitude, we should discuss his need for shelter wherever he goes. Possibly he cannot buy or rent for any less than he is presently paying. He should investigate these areas before deciding to give up his present home. If he does want to maintain the property and he is willing to cooperate with us, we will do everything possible to try to get through this period of difficulty with him.

We are now able to determine what the customer is able to do. Shelter is a necessity which follows only food and medical attention. We must anticipate the funds needed in the latter two areas as nearly as possible to determine his ability to make the house payment. For the man who is fully employed or who is drawing 95% of his base wages even though unemployed, the delinquency must be corrected as soon as possible since his situation may change for the worse in the future. We will set up a schedule of payments that fits his budget and that is satisfactory to HCS. He must make the required payments unless his situation changes, at which time we will schedule another conference.

For the man who is drawing unemployment only or who has no income at all, he may be faced with a situation in which there will be no funds to pay to us. Or he may have the ability to make only small partial payments, such as interest and/or escrow. In either instance, he will soon have a seriously delinquent loan unless his circumstances improve. We feel that if this is the case, we must, if the customer's attitude remains good and we can see that there is a possibility of improvement in circumstances in the future, be ready to carry the arrearage on his loan for possibly several months, with small or even no payment. In this instance, it is not possible at this time to say how long we will continue to carry the delinquency. We will require that the borrower contact us at least monthly at which time we will reevaluate his circumstances, the care he is giving the property, and his equity situation. We must be prepared to move quickly should we decide there is not possible hope for recovery by the borrower.

We are already dealing with many of the circumstances discussed thus far. We know that more and more customers are going to be coming to us as unemployment rises and personal savings are depleted. We do not know how many customers will be out of work or how long the current economic crisis will last, but we will try, very briefly, to project what we think may be the delinquency pattern for our institution during the next 6 months.

We feel that the average unemployment rate for our lending area may reach as high as 14-15% during the next few months. This, of course, will depend largely on the automotive industry. If this is the case, we must consider that for the automotive employee, the supplemental unemployment benefit fund will likely be depleted by the end of March. Therefore, he will no longer be receiving 95% of his base wage and he then becomes a member of the latter group we have previously discussed. We must also remember that the Spring installment of real estate taxes will be due during the period for which we are projecting, as well as State and Federal income taxes. Considering these areas; we feel that we could be facing a delinquency pattern that might reach as high as 8-10% of our loan portfolio, as compared to the present 1.44%. We admit that the thought is shocking, but we must be realistic. If our people do not have the ability to pay, which would be the most bearable? Extremely high delinquency that may result from our working with our borrower or possibly an enormous real estate owned portfolio that would require property management, renters, and eventually resale. Certainly, we must look beyond the current crisis to the day when our borrower will again be able to resume payments. Our primary goal is to help him purchase his home.

We are confident that the reorganization taking place at this time will aid us in handling all the problems that are coming. Fortunately, many changes have already occured and we are functioning in these new areas. We all realize the need for cooperation within the Association and the need for each of us to actively serve our customers during this time. We now have the organization it will take to handle the current problem.

All of the above point to the grave problem we are facing. But at the same time, this may be one of the most influential times we have ever had in our communities. We have an opportunity to show our borrowers and others in the community the strength of HCS as well as our willingness to serve our customers. Our response in this critical time may have great impact on the future growth of our Association.

EXHIBIT B

POLICY AND PROCEDURE FOR HANDLING PAST DUE ACCOUNTS: HENRY COUNTY SAVINGS AND LOAN ASSOCIATION NEW CASTLE, INDIANA

This policy and procedure is to be used as a guideline in handling all past due loans at HCS. At the present time, this includes real estate mortgages, real estate contracts, home improvement loans, and mobile home loans. This is meant to serve as guide and may not apply in every case. Any problems which cannot be handled by following these procedures should be discussed with Donald E. McNeil, Vice President, Real Estate Mortgage Lending.

I. 1-15 Days Past Due

  A. Normal notice routine will be followed in most cases. First notice approximately 8-10 days after due date. Second notice 15 days after due date.

II. 15-30 Days Past Due:

  A. Contact with borrower by phone and/or letters. Care should be taken to secure the needed payment and also to establish the reason for the delinquency. The importance of prompt payments and credit standing should be discussed with the borrower. A review of their note concerning due dates should also be made so that they realize their obligation.

III. 30-60 Days Past Due:

  A. Once an account has reached 30 day delinquent, our collection effort should be very concentrated. Personal contact should have already been made. If corrective measures are not made prior to this time, they should be made immediately. In some instances field contact will be necessary. If so, close attention should be given to the subject property. (A report should be given to the collection supervisor of the condition of the property any time a field visit is made).

IV. 60 Days Past Due

A. At this point all of the borrowers should be scheduled to meet with a Delinquency Review Board composed of those whom the President chooses. This Board would examine the current condition of the borrowers to determine their financial capabilities. A repayment schedule should be set up, with their cooperation, which is satisfactory to the Association and within the customer's means. If no solution is found to return the loan to a current state, the Board will recommend futher action to liquidate the property.

If a repayment schedule established by the Review Board is broken without due cause, the account should be submitted to the Loan Committee for immediate action.

V. 90 Day Past Due

A. If an account becomes 90 days delinquent and a satisfactory repayment plan has not been established, the loan should be submitted by the Review Board to the Loan Committee to determine if legal action is in order.

EXHIBIT C

INDIANA FORCLOSURE PROCESS

In those cases where legal action is initiated, both the lender's and the borrower's rights are governed by Indiana statute and the provisions of the instruments evidencing the debt. Failure by a borrower to make payment when due constitutues default under the Indiana statute, and renders the mortgage subject to a foreclosure action, unless the loan documents provide otherwise. However, we, as a lender, have always chosen to allow a minimum default period of ninety days prior to initiating action. When a lender has elected to foreclose, the statutes provide a redemption period for the borrower. The duration of this period is determined solely by origination date. Loans closed prior to July 1, 1975 are subject to a six-month redemption period; loans closed subsequent to that date require a three-month redemption period. The purpose of this period is to afford the borrower one last opportunity to satisfy his obligation, and thus retain his home. While in redemption, the borrower is permitted by statute to continue occupying his residence.

If the borrower has not redeemed prior to the expiration of the specified period, the mortgage is ordered foreclosed, and the Sheriff is authorized (after proper legal notice) to sell the property, free and clear or all liens, by public auction. Proceeds generated by the auction, after payment of costs inherent in the sale, are distributed to the lienholders in accordance with the priority of their claims, with any remaining funds returned to the borrower.

Senator HEINZ. Mr. Prior, thank you for a very timely statement. I hate to cut anybody off who is saying something nice about my own legislation. [Laughter.]

We thank you for your brevity.

Mr. Swanson.

LAWRENCE SWANSON, DIRECTOR OF HOUSING DEVELOPMENT AND RESEARCH, ACTION HOUSING, PITTSBURGH, PA.

Mr. SWANSON. My name is Larry Swanson, director of Housing Development and Research for Action Housing in Pittsburgh.

Senator HEINZ. Before you go any further, let me pay a special tribute, Mr. Swanson, to you and the people in Action Housing who have worked very closely with me and my staff in helping develop title VII, the aforementioned. Mr. Rockwell, we welcome you and we thank Dollar for its input into the process as well.

Action Housing is, if you will, a community conglomerate of interested citizens representing quite a broad cross section of mutual community interests.

We are pleased to see you.

Mr. SWANSON. Thank you for those kind words, Senator. It will make it easier for me to share my time with Mr. Rockwell here, since I don't have to do the introduction now.

Senator HEINZ. Without objection, that part of the introduction is now a part of the record.

Mr. SWANSON. In October and November, Action Housing, working with the Mon-Valley Unemployed Committee, completed an initial survey of 351 unemployed workers drawn from the membership in the United Steel Workers Union. But utilizing a survey in combination with statistics provided by the Mortgage Bankers Association, we were able to define the problem in our region.

Of the some 245,000 mortgagors in our region, some 15,000 are delinquent and 2,000 are in foreclosure. For every unemployed homeowner who was delinquent, three others are close to delinquency and will probably be so once unemployment compensation has been exhausted.

This could involve another 26,500 mortgagors in our four-county region.

A program to assist unemployed homeowners was shaped with the input of private mortgage lenders, insurance officials, local and Federal Government officials, housing counselors, and unemployed homeowners. This process was formalized with the establishment of the Mortgage Delinquency Task Force.

It utilizes the available FHA, VA, and Farmers Home Mortgage Assistance mechanisms and also provides for a fund of last resort.

We have made our first foreclosure prevention loans and currently have 25 applications pending, some of which will be reviewed tomorrow, and over 125 loans in our process that will likely result in loans from the fund.

Each of these loans represents a situation in which the combination of private lender forbearance, mortgagor contribution, private mortgage insurance assistance mechanisms and Federal assistance programs were unable to prevent an unemployed person's potential mortgage foreclosure.

In Pennsylvania, the delinquency rate for conventional loans has risen from 2½ percent in 1977 to 4.43 percent in 1982, at a time when the statewide unemployment rate rose from 8.1 percent to 12½ percent.

Conventional loan delinquency rates appear to be more directly related to unemployment rates than the delinquency rates of Federal guaranteed and insured loans. If we apply available Pennsylvania delinquency rates between 1977 and 1982 to the number of conventional loans, then the number of delinquent conventional loans in Pittsburgh has risen from 4,800 to 8,600.

If we include in our estimates the impact of the higher unemployment rates in the Pittsburgh area, the total number of delinquent potential loans is projected to be in excess of 11,000, or 5.83 percent of the conventional mortgage holders.

If moderate to high levels of unemployment are to be maintained in our area as part of the price of national economy recovery, then the assistance should be provided to the individuals in the communities that must bear this burden.

We fully recognize that the real solution to this problem is that of returning to higher levels of employment, and in our area we must now face the prospect of higher than national unemployment rates and structural unemployment for the next several years.

A Federal responsive program to bridge this time of crisis is absolutely essential.

I would like to give the rest of my time to Mr. Rockwell.

[The complete statement follows:]

Statement of Lawrence A. Swanson

Mortgage Foreclosure and Delinquency Problems in the Pittsburgh Area

May 5, 1983

ACTION-Housing, Inc. is a private, non-profit community based organization that has been working to improve housing and neighborhoods for the last twenty-five (25) years in the City of Pittsburgh and Allegheny County. We are supported, in part, by the United Way and have been directly involved in housing development and rehabilitation, research on community housing problems, as well as marketing and education. Since September of 1982 we have been working with unemployed homeowners, local lending institutions and local governmental representatives on the critical problems of mortgage delinquency and mortgage foreclosure.

In September of 1982 representatives of the Mon-Valley Unemployed Committee approached ACTION-Housing for assistance in responding to the then increasing problems their members were having with mortgage payments. ACTION-Housing arranged for a series of discussions between the Mon-Valley Unemployed Committee and representatives of key lending institutions as well as public officials.

It was agreed by all parties that there was an emerging problem. Before a meaningful response could be developed we needed to understand its scope. Specifically, it was important to know how many mortgagors were delinquent or about to become delinquent, how this delinquency was related to unemployment compensation payments and what proportion of mortgagors were at high risk due to the size of their payments.

In October and November, ACTION-Housing working with the Mon-Valley Unemployed Committee completed an initial survey of 351 unemployed workers drawn from the membership in two union locals. A follow-up survey was completed with 105 of this sample who were already experiencing mortgage delinquency or foreclosure problems.

By utilizing our survey in combination with statistics provided by the Mortgage Bankers Association we were able to define the problem in our region. Of the some 245,000 mortgagors in the metropolitan region some 15,000 are delinquent and 2,000 are in foreclosure. For every unemployed homeowner who is delinquent three (3) others are close to delinquency and will probably be so once employment compensation has been exhausted. This would involve another 22,500 mortgagors in our four (4) County region.

In addition we concluded that:

1. Unemployment has hit primarily the young and the middle-aged workers. The youngest were hit first, but the middle-aged, whose family obligations and household investments make them less able to bear extended unemployment, have been hit equally hard.
2. The people surveyed have borne an extraordinarily long period of unemployment--five months at the least, and frequently up to 14 months.
3. The duration of unemployment has driven most mortgagors close to delinquency--two thirds of the mortgagors. Many are also behind on utility bills.
4. Both the delinquent and near-delinquent mortgagors represent a broad cross-section of the unemployed rather than any definable sub-group of them. This is truly a community problem.
5. The mainstay of the household finances for the unemployed is their unemployment benefits. The long duration of unemployment

has dissipated their private reserves of savings and credit.

6. Most of these people will lose their benefits sometime between December 1982 and March 1983. Though some may be able to forestall delinquency a month or two beyond that, during the second quarter of 1983 we will begin to learn the real dimensions of the crisis facing our area's unemployed mortgagors.
7. The standard remedies of interest-only partial payments and refinancing will not address the payment problems for many. Most homeowners in this sample have bought their homes in the past ten years. Their monthly payments consist almost entirely of interest and they have little equity beyond their initial downpayment, so that the refinancing options are very limited.
8. The FHA and VA assignment programs, even if used to their fullest extent, apply to only one-fourth to one-half of the delinquent and near-delinquent borrowers. The remaining mortgages are either privately insured or uninsured conventional loans.

In shaping a program to respond to the delinquency and foreclosure crisis, ACTION-Housing sought the advice of private mortgage lending and insurance officials, local and federal government officials, housing counselors, and unemployed homeowners. This process was formalized with the establishment of the Mortgage Delinquency Task Force. The Task Force developed, refined, and unanimously approved a six-point plan as a response to the delinquency and foreclosure crisis.

1. Maximize lender-homeowner contact and communication at the earliest possible time when a delinquency problem is approaching.

A number of informational and promotional campaigns are now in process to encourage mortgagors to "Talk to Your Lender."

2. Make the best possible use of the currently available partial payment, forebearance, and refinancing options, with active third-party support to assist in bringing these arrangements to fruition whenever appropriate.
3. Coordinate and support financial and legal housing counseling services from the five (5) local non-profit agencies providing these services.
4. Work with all parties concerned to increase the acceptance rate in the established FHA and VA assignment programs.
5. Support the demonstration of an innovative temporary mortgage assistance program with the private mortgage insurance industry as suggested by the Mortgage Guaranty Insurance Corporation (MGIC), and encourage other private mortgage insurers to offer similar programs. The MGIC program would allow the lender to receive advances against insured losses to prevent foreclosure.
6. Establish, fund and operate a mortgage foreclosure prevention fund that will act as a last resort to prevent foreclosure, to be financed and operated by cooperating public and private agencies and used in concert with the first five measures in the plan.

The above recommendations are meant to maximize the use of currently existing individual and organizational resources both public and private, without shifting primary responsibility for averting delinquency and foreclosure from the individual mortgagor. Protection of homeownership and the institutions that have financed ownership is a critical community concern affecting both the economic strength and social stability of an area. The plan outlined above represents an initial step in the process of responding the the problems of delinquency and foreclosure.

We have set up a procedure and a loan committee for the foreclosure prevention fund and have made our first loans. Currently we have twenty-five (25) pending applications and some one hundred twenty-five (125) in our loan fund process. We will assist as many homeowners as our resources allow. We hope to provide assistance from the fund to at least 200 homeowners. We further assume that most homeowners will be helped by the other steps in the program.

Since our initial study we have completed some limited additional analysis on delinquency among conventional loans. In Pennsylvania the delinquency rate has risen from 2.5% (2nd Quarter of 1977) to 4.43% (4th Quarter of 1982) at a time when the Statewide unemployment rate rose from 8.1% to 12.5%. Conventional loan delinquency rates apperar to be more directly related to unemployment rates than the Federally guaranteed and insured loans. If we apply available Pennsylvania delinquency rates between 1977 and 1982 to the number of conventional loans then the number of delinquent conventional loans in the Pittsburgh area has risen from 4,866 to 8,672. If we include in our estimates the impact of unemployment rates in the Pittsburgh area then the total number of conventional loans is in excess of 11,000 (11,410) or 6.36% of conventional mortgage holders.

Both our analysis of unemployed mortgagors and the monitoring of mortgage activity have demonstrated that longer term unemployment results in increasing conventional loan delinquency. If moderate to high levels of unemployment are to be maintained in our area as a price of the national economic recovery, then assistance should be provided to the individuals and communities that must bear this burden.

A leading regional economic indicator compiled by Mellon Bank now projects unemployment rates in the 13% to 14% in the next twelve (12) months. Even this high level of unemployment is based upon the assumption that a national economic recovery will proceed as predicted. It appears as if long term unemployment is almost assured in our region as the local economy is restructured.

All of our efforts have been to focus on what we could do with local resources to solve this problem. This response, we hope, will be effective in meeting the immediate problem.

It is also clear to us that we need to have State or Federal action to bring long term and broad based solutions to the delinquency and foreclosure problem. Today, we would like to identify what we think are the key ingredients of such a solution.

First, any program of assistance must seek to preserve the contract between the mortgagor and the mortgagee. This is in the best interest of the mortgagor, the mortgagee and the housing industry in general.

Second, all parties agree that it is essential to prevent foreclosure and keep unemployed mortgagors in their homes. After we have utilized existing resources, this effectively means financial assistance to the mortgagor to allow him or her to meet terms of a negotiated agreement with the lender. Such assistance should be as long term as possible, at least 18 months and hopefully 24 months. We believe it is necessary to bring

Delinquency Among Conventional Loans in the Pittsburgh Area

County	Owner Occupied Units	Number Mortgaged	Number Conventional Loans	No. Delinquency Loans Based on Penna. Rate	No. Delinquency Loans When Delinquency Rate is Adjusted for Unemp.	Unemployment Rate for Jan. 1983
Allegheny	306,094	163,845	125,611	5,564	6,557 (5.22%)	15.5%
Beaver	44,172	22,055	18,314	811	1,472 (8.04%)	25.0%
Westmoreland	86,138	41,361	34,522	1,529	2,275 (6.59%)	20.1%
Washington	45,354	19,740	17,338	768	1,106 (6.38%)	19.4%
	481,758	247,001	195,785	8,672	11,410	

stability to the household until re-employment or retraining allows the individual to return to work. Such assistance must recognize that the mortgagor even without mortgage payments will be pressed to make utility payments, provide food and clothing and meet everyday living expenses. Once a person returns to work we must be sure the burdens of repayment are not too severe.

Thirdly, a program of assistance must protect the financial interests of the mortgage lending industry. Not only must we be concerned about individual institutions in our area we must consider the impact on the mortgage lending industry and the housing industry as a whole. Effectively, we must not make it less attractive to invest in Pennsylvania real estate then in any other State. We must be able to attract capital from the secondary mortgage market to have a healthy home building and real estate industry. Increasingly, we are turning to non-traditional sources, such as pension funds, to invest in real estate. At the same time a variety of mortgage instruments are being used to help households qualify to purchase homes and make them affordable. Many of these instruments rely on secondary mortgage market investments.

And finally, we believe a program of assistance should recognize and utilize local organizations to the maximum extent possible. Mortgage delinquency counseling by budget and housing counseling agencies is essential to the long term stability of the situation. Private lenders and insurance agencies should be fully involved in the solution given the interest and commitment they have demonstrated.

We fully recognize that the real solution to this problem is that of returning to high levels of employment. But in our area we must now face the prospect of higher than national unemployment rates and structural unemployment for the next several years. A federally sponsored program to bridge this time of crisis is absolutely essential.

Not only does it respond to pressing problems faced by mortgagors and lending institutions, it also will help preserve the investments we have already made in housing rehabilitation, new construction, community facilities and the infrastructure of our communities.

Senator HEINZ. Mr. Rockwell.

SAM ROCKWELL, DOLLAR SAVINGS BANK, PITTSBURGH, PA.

Mr. ROCKWELL. My name is Sam Rockwell, vice president of real estate lending for Dollar Savings Bank of Pittsburgh.

It has only been within the past few months that we have been feeling the full effect of the mortgagor who, through no fault of his own, finds himself in a position where his unemployment compensation has run out and he is unable to meet his mortgage payments. This is an individual who has always made his payments on time, but is now unable to meet the obligations.

A year ago, 4 percent of our delinquent portfolio was of this type of borrower. This year it is 10 percent.

It has to be a frightening and emotional experience to realize that you may lose your home because you are a victim of the changing economic scene. In most cases, there is very little equity, so the borrower is reluctant to approach the lender for assistance.

If the delinquency goes beyond the point of no return, we are then faced with initiation of foreclosure proceedings. Banks do not want to foreclose on real estate; for the bank and the consumer it is a "no win" situation. We do not generate income by foreclosure on a personal residence.

At best, we terminate an ongoing loss situation, and that termination is expensive, a cost above and beyond the loss already incurred by the lack of income from that asset.

We are now on the horns of a dilemma. Do we protect our depositor or our borrower?

No matter which course we choose, someone will be hurt. Should we decide in favor of extended forbearance for all unemployed homeowners, we are placing heavy burdens on the bank, and that does not take into account the possible jeopardy we are placing on the depositors' funds.

Should we follow the course of strict adherence to the legal remedies available to us in such cases, there will be a large number of innocent homeowners and their families displaced.

In my mind, neither solution is acceptable. We at Dollar Bank have made a commitment to assist the victims of unemployment to the best of our ability. Unfortunately, in many cases we are not able to go far enough.

Dollar Savings Bank firmly believes, if assistance is to be meaningful, it can only be accomplished if three conditions exist.

One, the borrower must be identified as a true victim of the present unemployment level. This restriction excludes the chronic delinquent who has been a problem prior to the present situation.

Two, we require a clear channel of communication between the bank and customer. The borrower and lender alike must understand the situation of the other. We have found that professional counseling by a trained social worker can be very effective and helpful to both the borrower as well as the bank. It provides an impartial third party to interface with some objectivity.

Three, there must be a commitment by the borrower. He or she must understand that sacrifices will be necessary. If we can establish the above three items, we have a place to start.

We employ a group called Housing Opportunies, Inc. in McKeesport for counseling and factfinding. We feel the cost can be justified. We will continue to follow this program, since the short-term results have been excellent.

The measures we have employed are only stopgap. With what little money our borrowers have to work with, minimal savings and unemployment compensation are either depleting rapidly or have already vanished.

All the counseling or reduced payments in the world won't help if the borrower doesn't have any money to work with. We are rapidly approaching that point.

The Unemployed Homeowners Relief Act of 1983 could provide a much needed tool to assist both lender and borrower to bridge these unusually tough times.

I believe that this legislation should provide for the lender to forbear for a longer period than usual, as well as providing for the lender to document the efforts made to work with the unemployed borrower.

We have found that public/private efforts, when well structured, can be very successful. We are not unwilling to assume some of the responsibility of assisting mortgagors who, through no fault of their own, find themselves in this situation.

We do believe that it will take more than the assistance that we can offer. It will be necessary for public and private sources to combine with lenders to help avert what might become a crisis situation.

The Unemployed Homeowners Relief Act will go a long way toward helping.

Thank you.

[The complete statement follows:]

STATEMENT

Good morning, my name is Sam Rockwell, Vice President of Real Estate Lending for Dollar Savings Bank of Pittsburgh.

I am pleased to have this opportunity to discuss the mortgage foreclosure problem for the unemployed as it related to Dollar Savings Bank.

It has only been within the past few months that we have been feeling the full effect of the mortgagor who through no fault of his own now finds himself in a position where his unemployment compensation has run out and he is unable to meet the mortgage payment. This is an individual who has always met his payments on time, but now is unable to meet his obligations.

It has to be a very frightening and emotional experience to realize that you may lose your home because you are a victim of a changing economic scene. In most cases there is very little equity so that the borrower is reluctant to approach the lender for assistance. If the delinquency goes beyond the point of no return, say four months, we are then faced with the initiation of foreclosure proceedings.

Banks do not want to foreclose on real estate. For the bank and the consumer it is a no win situation. We do not generate income by foreclosure on a personal residence. At best, we terminate an ongoing loss situation. And that termination is expensive, a cost above and beyond the loss already incurred by lack of income from the asset. We are now on the horns of a dilemma—do we protect our depositor or our borrower. No matter which course we choose, someone will be hurt. Should we decide in favor of extended forbearance for all unemployed homeowners, we are placing heavy burdens on the bank and that does not take into account the possible jeopardy we are placing on the depositors' funds. Should we follow the course of strict adherence to the legal remedies available to us in such cases, there will be a large number of innocent homeowners and their families displaced. In my mind, neither solution is acceptable.

We at Dollar Savings Bank have made a commitment to assist the victims of unemployment to the best of our ability. Unfortunately our ability, in many cases, cannot go far enough. I would like to share with you some cases pulled from our files which demonstrate the steps we have taken.

Dollar Savings Bank firmly believes if assistance is to be meaningful it can only be accomplished if three conditions exist:

(1) The borrower must be identified as a true victim of the present unemployment level. This restriction excludes the chronic delinquent who has been a problem prior to the present situation.

(2) We require a clear channel of communication between bank and customer. The Borrower and lender alike must understand the situation of the other. We have found that professional counseling by a trained social worker can be very effective and helpful to both the borrower as well as the bank. It provides an impartial third party to interface with some objectivity.

(3) There must be a commitment by the borrower. He or she must understand that sacrifices will be necessary.

If we can establish the above three items, we have a place to start. We utilize a group called Housing Opportunities, Inc., which Dollar Savings Bank pays $6.00 per hour for counseling and fact finding. We feel this is money well spent and we will continue to follow this program since the short term results have been excellent.

The measures we have employed are only "stop gap". What little money our borrowers had to work with, minimal savings and unemployment compensation, are either depleting rapidly or have already vanished. All the counseling or reduced payments in the world won't help if the borrower doesn't have any money to work with. We are rapidly approaching that point.

The "Unemployed Homeowners' Relief Act of 1983" would provide a much needed tool to assist both lender and borrower to bridge these unusually tough times. I believe that this legislation should provide for the lender to forbear for a longer period than usual as well as providing for documenting the efforts made by the lender to work with the unemployed borrower.

We have found that public-private efforts when well structured can be very successful. We are the largest VA lender in the Greater Pittsburgh area and have successfully participated in numerous Urban Renewal projects which have required a partnership of public and private interests.

We are not unwilling to assume some of the responsibility of assisting mortgagors who through no fault of their own find themselves in an impossible position where they are unable to meet their monthly mortgage obligation. We do believe that it will take more than the assistance that we can offer. It will be necessary for public and private sources to combine with the lenders to help avert what might become a crisis situation. The "Unemployed Homeowners' Relief Act" would go a long way towards helping.

Thank you.

RESPONSE TO SENATOR RIEGLE'S QUESTIONS TO SAM ROCKWELL, RE: MORTGAGE FORECLOSURE ASSISTANCE

Question. You state that the problem requires more assistance than you can offer. What will happen if such a system as in our bill is not forthcoming?

Answer. The Bank cannot afford to forebear indefinitely and if there appears that there is no immediate resolution after an extended forbearance period, the Bank will have to resort to the remedies provided for in the mortgage.

Question. What are lenders in hard-pressed areas likely to do if Congress does not inact additional assistance?

Answer. I believe that most lenders will try to work with the borrower providing that they are able to see some light at the end of the tunnel and are able to take advantage of programs such as Action Housing's and MGIC's. Federal mortgage foreclosure assistance would open that window and allow lenders additional time to work with borrowers. This would be especially important in the "hard-pressed areas".

Senator **HEINZ**. Thank you very much, Mr. Rockwell. Mr. Schechter.

STATEMENT OF HENRY SCHECHTER, DIRECTOR, AMERICAN FEDERATION OF LABOR/CONGRESS OF INDUSTRIAL ORGANIZATIONS, WASHINGTON, D.C.

Mr. Schechter. Mr. Chairman, I appreciate the opportunity to present before you the views of the AFL–CIO on the subject of today's hearings.

The Unemployed Homeowners Relief Act is a welcome approach toward needed temporary relief to alleviate a growing problem of the loss of homes.

The number of home foreclosures in process rose from 119,000 in the last quarter of 1981 to 181,000 in the last quarter of 1982. The level of mortgage foreclosures increased as the number of unemployed increased and, more particularly, as the number that had been unemployed 27 weeks or more increased to about 3 million last month.

Between mid-September and the end of February, a net of about 1 million unemployed workers exhausted their Federal supplementary compensation benefits, the last resort. As of the end of March, there were 655,000 receiving such benefits.

Based on projected unemployment rates assumed in the April revision of the President's budget and the projected size of the labor force, total unemployment will decrease only gradually from the present 11.4 million to an average of 10 million in 1985.

Over the next 2 years, large numbers of people will experience extended periods of unemployment and will need temporary loan assistance to avoid loss of homes through foreclosure.

Renters also suffer extended unemployment and resultant displacement from their homes, as reflected in anecdotal news reports of homelessness and the statistics on the numbers of doubled-up families.

Legislation to protect unemployed homeowners against foreclosure should provide similar assistance to unemployed renters facing eviction.

The proposed Homeowners Relief Act would require the lender to advise the mortgagor of loan assistance that could be made available to him under the act, but it does not assure that such assistance will be made available. Such a loan would more readily be made by a lender if his share of a possible loss were to be reduced from 10 percent to 5 percent.

The mechanics of the second mortgage loan assistance with a full amount to cover up to 27 months of first mortgage payments, to be borrowed before the fourth month, can result in an unmanageable debt service burden for the homeowner when he has to start repaying that second mortgage in 12 years, along with the first mortgage.

In such instances it should be made possible to extend the guaranteed loan to a total maturity of up to 20 years, with an option to the lender to assign the loan to the Secretary after 12 years upon forfeiture of 1 percent of the outstanding loan amount.

The bill might be discriminatory against unemployed mortgagors whose loan is held by a lender who is not subject to relevant Federal supervision. The Federal regulators would be required to notify lenders under their supervision to notify mortgagors about assistance available under the act and also to relax limitations.

With regard to mortgage delinquencies, in order to encourage forbearance, the Secretary of HUD is assigned a similar function with respect to all other "approved" mortgagees. However, there may be some question whether the Secretary could exercise such authority over approved mortgagees in connection with mortgages that are not FHA-insured.

There may also be unemployed mortgagors whose loans are held by other than approved mortgagees. The Secretary of HUD should be given clear authority to exercise his assigned functions effectively in all such cases.

Now, section 704 (e) and (f) would leave to the Secretary the authority to determine whether a loan to a certain mortgagor may be federally guaranteed and would preclude such a guarantee if the Secretary determines that it bears an interest rate or fee that is excessive.

Section 705 provides that a guarantee is mandatory upon certain certifications being made by the lender. This apparent conflict should be resolved by language making clear the Secretary's authority in this matter.

The AFL-CIO urges that there should be added to the bill an authorization for $100 million to be used for Federal loans to unemployed renters to prevent evictions from their homes.

A brief paragraph, if I may, with regard to proposed legislation affecting Fannie Mae. The proposed amendments under the Charter Act would greatly alter the balance between Fannie Mae obligations to help meet low and moderate income housing finance needs and the benefits that were conferred upon Fannie Mae in 1968, which were well described by previous witnesses.

The benefits to Fannie Mae would not be changed. On the other hand, the various proposed changes in legislation would direct Fannie Mae resources more into other investments than low and moderate income housing and would greatly dilute the regulatory powers of the Secretary of HUD, which are designed to provide power to see that the public interest function of Fannie Mae is carried out.

The Secretary's power should not be diluted, and the change in Fannie Mae investment power should be tempered as described in my full statement.

Thank you.

[The complete statement follows:]

83-43

Statement of Henry B. Schechter, Director
Office of Housing and Monetary Policy
Before the Housing and Urban Affairs Subcommittee
of the Banking, Housing, and Urban Affairs Committee
of the United States Senate
on Mortgage Foreclosure and Secondary Market Issues
May 5, 1983

SUMMARY

I appreciate the opportunity to present before you the views of the AFL-CIO on proposed legislation for mortgage payment relief for unemployed homeowners and to comment briefly on secondary mortgage market issues.

The proposed Unemployed Homeowners Relief Act is a welcome approach toward needed temporary relief to alleviate a growing problem of loss of homes. The number of home foreclosures in process rose from 119,000 in the last quarter of 1981 to 181,000 in the last quarter of 1982.

Indications are that the upward trend will continue. The Federal Home Loan Bank Board delinquency loan ratio, based on mortgage amounts, rose from 1.20 percent to 2.36 percent between July 1981 and February 1983. The level of mortgage foreclosures increased as the number of unemployed increased, and more particularly as the number that had been unemployed 27 weeks or more increased, to about 3 million last month. The latter may be on "extended benefits" or on Federal Supplementary or FSC benefits -- the last resort, or have exhaused their benefits completely. Between mid-September and the end of February, a net of about one million unemployed exhausted their FSC benefits; and as of the end of March there were 655,000 receiving such benefits.

Based on the projected unemployment rates assumed in the April revision of the President's budget and the projected size of the labor force, total unemployment will decrease only gradually from the present 11.4 million to an average of 10 million in 1985. Over the next two years, large numbers of people will experience extended periods of unemployment and will need temporary loan assistance to avoid loss of homes through foreclosure.

Renters also suffer extended unemployment and resultant displacement from their homes, as reflected in anecdotal news reports of homelessness of individuals and families and in statistics on numbers of doubled-up families. Legislation to protect unemployed homeowners against foreclosure should provide similar assistance to unemployed renters facing eviction.

The proposed Unemployed Homeowners Relief Act would require the lender to advise the mortgagor of loan assistance that could be made available to him under the Act, but it does not assure that such assistance will be made available. Such a loan would more readily be made by a lender if his share of a possible loss were to be reduced from 10 percent to 5 percent.

Since a lender may have been forebearing for more than three months prior to the effective date of the proposed Act, it should, in such circumstances, permit, in the amount of the guaranteed second mortgage loan to assist the homeowner, arears in first mortgage payments for more than three months, perhaps up to six months.

The mechanics of the second mortgage loan assistance, with the full amount to cover up to 27 months of first mortgage payments to be borrowed before the fourth month, can result in an unmanageable debt service burden for the homeowner when he has to start repaying that second mortgage in 12 years, along with the first mortgage. In such instances, it should be made possible to extend the guaranteed loan to a total maturity of up to 20 years, with an option to the lender to assign the loan to the Secretary after 12 years upon forfeiture of one percent of the outstanding loan amount.

The bill might be discriminatory against unemployed mortgagors whose loan is held by a pension fund, life insurance company, individual, or state-chartered institution that is not federally insured, and even FNMA and FHLMC, which are not subject to relevant federal supervision. The regulators would be required to notify lenders under their supervision to notify mortgagors about assistance available under the Act, and also to relax limitations with regard to mortgage delinquencies in order to cause or encourage forebearance. The Secretary of HUD is assigned a similar function with respect to all other "approved mortgagees." However, unless it is spelled out, there is a question whether the Secretary could exercise such authority over approved mortgagees in connection with mortgages that are not FHA-insured. There may also be unemployed mortgagors whose loans are held by other than approved mortgagees. The Secretary of HUD should be given clear authority to exercise his assigned functions effectively in all such cases.

While Section 704(e) and (f) would leave to the Secretary the authority to determine whether a loan to assist a mortgagor may be federally guaranteed, and would preclude such a guarantee if the Secretary determines that it bears an interest rate or fee that is excessive, Section 705 provides that a guaranty is mandatory upon certain certifications being made by the lender. This apparent conflict should be resolved by language making clear the Secretary's authority in this matter.

Finally, the AFL-CIO urges that there should be added to the bill an authorization for $100 million to be used for federal loans to unemployed renters to prevent evictions from their homes.

As to legislation affecting the Federal National Mortgage Association, as I understand it, the proposed amendments to the Charter Act would greatly alter the balance between FNMA obligations to help meet low- and moderate- income housing finance needs and the benefits that were conferred upon FNMA in 1968. The benefits to FNMA which include Treasury authority to lend FNMA $2¼ billion, exemption from state taxation (except real estate taxes), Federal Reserve purchase of FNMA paper in open market operations, exemption of its securities from SEC regulation -- and many others, would not be changed. On the other hand, various proposed changes in legislation would direct FNMA resources more into other investments than low- and moderate-income housing and would greatly dilute the regulatory powers of the Secretary of HUD which are designed to provide power to see that the public interest function of FNMA is carried out. The Secretary's power should not be diluted, and the change in FNMA investment powers should be tempered as described in my full statement.

* * * * *

The Need for Legislation

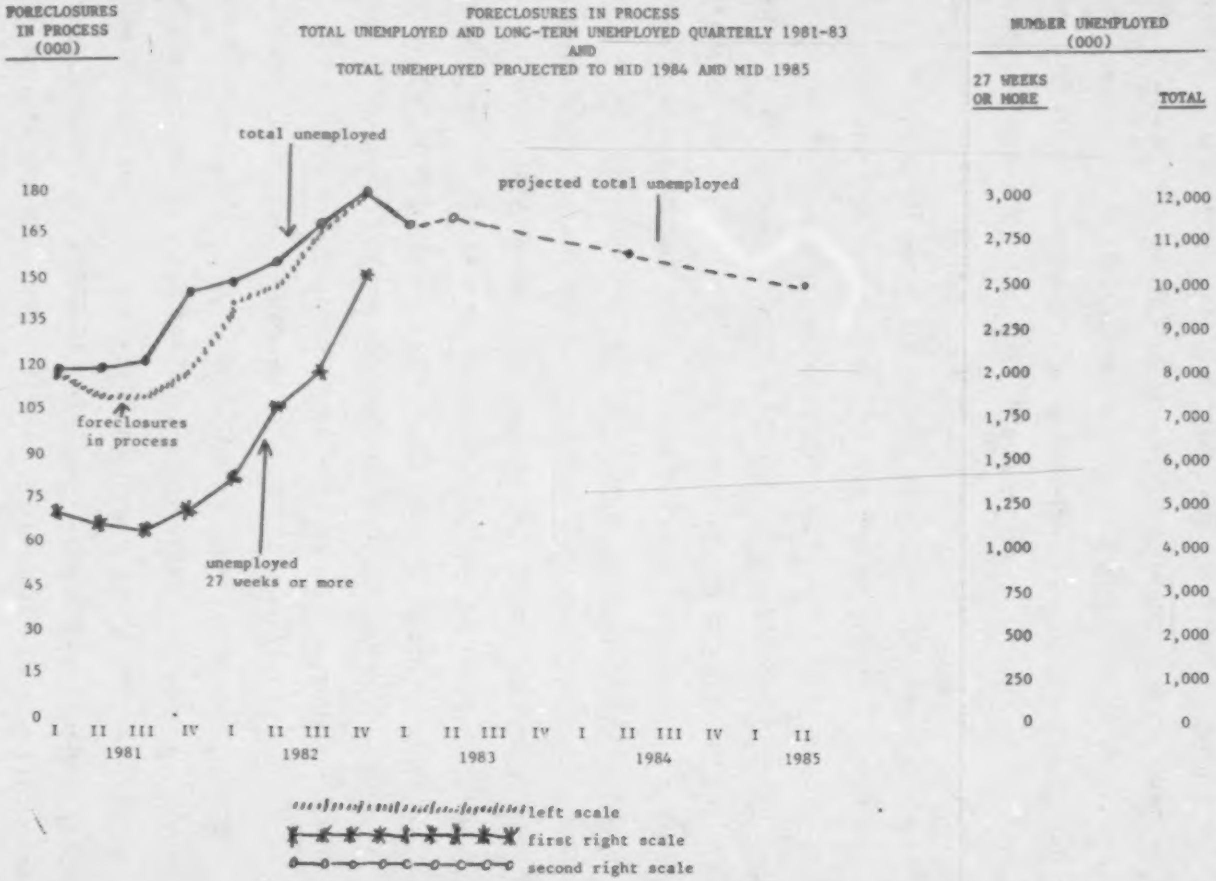
The Unemployed Homeowners Relief Act of 1983, the Heinz-Riegle amendment, is a welcome approach toward much needed temporary relief to alleviate a growing problem of loss of homes. According to a quarterly survey of the Mortgage Bankers of America, in 1982 there was a marked rise over 1981 in the initiation of home foreclosures. During 1981, the number of home foreclosures started each quarter year ranged between 40,000 and 46,000. In 1982, the number of home foreclosures started quarterly was 54,000 in each of the first two quarters, and 59,000 in each of the last two quarters, for an annual total of 226,000. At the end of 1982, about 180,000 homes were in the process of being foreclosed.

Other data measuring events which precede mortgage foreclosures indicate some further increaes and a high level of home foreclosures for some time to come. The Federal Home Loan Bank Board's delinquency loan ratio, for example, has risen steadily from 1.20 percent in July 1981 to 2.36 percent in February 1983. This ratio measures the dollar amount of mortgage loans and contracts delinquent 60 days or more as a percent of total mortgages and contracts held at end of month by the financial institutions included in the survey. As the delinquency ratio increases, the probability of an increased rate of foreclosures also grows.

A fundamental cause of increased foreclosures is the prolonged high level of unemployment. As shown on the chart on the next page, the level of mortgage foreclosures increased as the number of unemployed increased, and more particularly as the number that had been unemployed 27 weeks or more increased, reaching 2.85 million in March 1983. The latter had been unemployed for longer than the 26-week term of regular unemployment insurance benefits; they then could in many states receive extended benefits for varying shorter terms. Those that exhaust the "extended" benefits may be eligible for Federal Supplementary Compensation (FSC) for periods between 8 and 14 weeks, the last step before running out of unemployment compensation support, and for many the last step before running out of income.

Between mid-September and the end of February, about 1.3 million unemployed had exhausted their Federal Supplementary Compensation, but an estimated two to three hundred thousand then again became eligible after Congress amended the law early this year. As of March 28, there were 655,000 persons receiving Federal Supplementary Compensation, indicating many more may soon be without a source of income.

FORECLOSURES IN PROCESS
TOTAL UNEMPLOYED AND LONG-TERM UNEMPLOYED QUARTERLY 1981-83
AND
TOTAL UNEMPLOYED PROJECTED TO MID 1984 AND MID 1985



Although the losses and suffering are not confined geographically, the threat to peoples homes is greatest in the places where joblessness is worst, including Illinois, Indiana, Michigan, Ohio, and Alabama. The table on the next page shows that these states appear on both the list of the ten states with the highest mortgage delinquency rates and the ten states with the highest joblessness.

Unfortunately, little in the way of relief is in sight, in view of the predicted high level of unemployment for the next several years. The number of civilian people actually working has remained virtually unchanged since December in the Labor Department's household survey. The number working has risen by less than 300,000 or three-tenths of 1 percent in the establishment survey. This represents no great resurgence in jobs and economic activity. The decline in the (civilian only) unemployment rate from 10.8 to 10.3 percent over the last three months reflects in part a 650,000 person reduction of the labor force shown by the survey data. Using the new labor force definition of civilians plus members of the armed forces, which showed an unemployment rate of 10.1 percent, the President's revised April budget predicts an annual average unemployment rate of 10.0 percent in 1983, 9.1 percent in 1984, and 8.4 percent in 1985. Applying those unemployment percentages to the Labor Department's projected size of the labor force indicates that the number of unemployed will decline to an average of 10 million by 1985.

That does not mean, of course, that the same 10 million people will remain unemployed for three years. As usual, there will be many people who will experience periods of unemployment and then find jobs. However, the continuing high level of unemployment suggests that large numbers will have extended periods of unemployment and significant curtailment of income over the next couple of years. It leaves no doubt of the need for a law to serve the purpose intended by the Unemployed Homeowners Relief Act of 1983.

	States with Highest Delinquency Rates 4th Quarter, 1982		States with Highest Unemployment (February, 1983)
Illinois	9.58	West Virginia	21.0
Puerto Rico	8.59	Michigan	16.5
District of Columbia	8.13	Alabama	16.1
Utah	7.66	Ohio	14.5
Indiana	7.62	Pennsylvania	14.1
New York	7.60	Illinois	13.8
Colorado	7.60	Tennessee	13.6
Michigan	7.42	Indiana	13.2
Ohio	7.41	Oregon	13.1
Alabama	7.32	Idaho	13.0

Delinquency National Rate: 5.70

Source: Mortgage Bankers Association; U. S. Department of Labor

Relief for Unemployed Renters

It must also be recognized, however, that unemployment and drastic curtailment or temporary loss of income is not confined to homeowners. Last week the New York Times reported that as many as 17,000 families in New York City are illegally doubled up in public housing projects, but the authorities hesitate to evict these families because they might have nowhere to go. Similar situations exist elsewhere in private as well as public housing; and as reported in news stories, there are unemployed homeless people and entire families being turned away from overcrowded shelters -- living in cars, in subways, in parks, and on the streets.

A few weeks ago a shantytown in a Houston park was in the spotlight after a young girl whose family lived there in a tent was burned to death in a fire. The local authorities then forced people to vacate the area.

Last winter a San Francisco Nob Hill church converted part of its space to a sleep shelter because people were sleeping in the park across the street. Other churches in San Francisco have also provided shelters and soup kitchens.

Despite a lack of systematic evidence about economic displacement and evictions from rental accommodations, there is mounting anecdotal evidence of a national problem of homelessness. The last (March 1982) annual survey figure on doubling up showed a large increase to a total of 2¼ million subfamilies living with others, the highest number since 1964. Homelessness has been shown to exist in many large cities, much of it the result of unemployment. People who lose their jobs may soon find their entire household economy collapsing, resulting in their eviction or forced departure from their apartments.

Action should be taken to help renters about to be evicted because of joblessness. The workers who bear the brunt of layoffs are very often young families, female-headed households, and minorities with little work seniority.

These people are also likely to be renters who have not yet been able to achieve homeownership. Legislation to protect homeowners against foreclosure should include similar temporary assistance for renters who will suffer a hardship from eviction.

Provisions of the Heinz-Riegle Amendment

The bill would provide for guarantee by the Secretary of HUD of a second mortage loan to be made by a lender to a mortgagor who has incurred a substantial reduction of income as the result of involuntary unemployment and who is in default on a mortgage loan on a single-family home which is his principal residence. The loan amount would be placed in an interest bearing escrow account from which there would be made monthly payments due under the first mortgage for principal, interest, taxes, ground rent and mortgage insurance for any delinquent payments for 3 months prior to the date of the loan and up to 24 months after that date. If there is a loss on the loan, the lender must absorb the first 10 percent.

In the period immediately after the Act would become effective, there may be loans on which the payments have been in arrears for five or six months because the lender has been forebearing. In such instances, the lender should be able to recoup payments for all of the preceding forebearance period. The bill should be amended so that the guaranteed loan amount could be large enough to cover a larger amount of arrears than only those for the three months immediately preceding the date of the loan.

There is a danger that conditions created by the terms of the financing arrangement may lead to a default at a later date. First, there is likely to be a higher interest rate charged on the guaranteed loan than the homeowner earns on the escrow amount. Second, the escrow account will decrease as payments are made out of it to meet the payments on the first mortgage loan. Therefore, interest earnings will decrease as the escrow balance decreases. At the same time, the guaranteed loan balance will increase as the growing net monthly excess of interest charges over interest earnings are added to it. Consequently, the guaranteed loan amount owed by the homeowner at the end of 24 months could be 15 or 20 percent greater than the original amount of that loan. Furthermore, as that loan amount then has to be repaid with interest, along with the resumed first mortgage payments, the total monthly payments for the homeowner could be one-third greater than the monthly payments that had been required before the homeowner received the assistance loan 24 months earlier. To provide for some alleviation in cases where there would be an unmanageable debt service burden, the Act should provide that the Secretary could extend the loan guarantee for an additional eight years up to a total of 20 years, and the lender should have the option of rewriting the repayment term accordingly and also selling the outstanding loan to the Secretary at the end of 12 years upon payment of a one percent penalty.

There is nothing in the bill which assures the homeowner that the lender will make such a loan. He is not required to do so. Each federal supervisory agency would, with respect to financial institutions subject to its jurisdiction, waive or relax limitations with respect to mortgage delinquencies in order to cause or encourage forebearance in mortgage loan foreclosures. The word "cause" seems to be out of context. Such supervisory agencies, furthermore, would be required to direct mortgagees to inform mortgagors against whom foreclosure proceedings had been initiated of the assistance available under the proposed legislation.

Although the lender will be required to advise the mortgagor of the assistance that is available under the law, the lender can tell the delinquent mortgagor (a) that he does not wish to make the type of loan that is permitted,

(b) that the mortgagor must accept the federally guaranteed loans on the terms offered by the lender at once or with little time for consideration, or (c) the lender might require an interest rate or fee that the Secretary of HUD determines is excessive which would preclude the guarantee of the loan.

If the program is to be effective in helping homeowners who cannot meet payments because of unemployment, it should require not only that the lender must advise the mortgagor of the availability of assistance under the law. It has to reduce obstacles to a lender making such a loan. Such a loan would be made available more readily by the lender if his required share of the loss, if any, was reduced from 10 to 5 percent. The lender would be protected for the balance. The loan would be guaranteed with the full faith and credit of the United States, and it could be sold to other investors, with a guarantee of timely payment of interest prior to the time of the mortgagor's repayment obligation and of 100 percent of principal and interest in subsequent years.

The bill might be discriminatory against unemployed homeowners whose mortgages are not held by financial institutions subject to a federal supervisory agency. Section 707 provides that the Secretary of HUD shall give similar notice to other approved mortgagees, regarding a relaxation of limitations with respect to mortgage delinquencies in order to cause or encourage forebearance, and to direct such mortgagees to inform mortgagors promptly as to the assistance available under the Act. With respect to those mortgagees who are not under supervision of the specified agencies: the Federal Reserve System, FDIC, Comptroller of the Currency, Federal Home Loan Bank Board, FSLIC, and the National Credit Union Administration Board, it is not clear whether all such mortgagees who might be holding mortgages are considered to be "approved mortgagees" subject to the jurisdiction of the Secretary for purposes of the proposed Act. There are state-chartered depository institutions without federal deposit insurance, life insurance companies that are not subject to federal supervision, as is true also of mortgage companies. Some of those may not even be FHA-approved mortgagees. Even those that are FHA-approved mortgagees are not subject to any supervision by the Secretary with regard to conventional mortgages, which is the only type of mortgages for which the proposed program would be available. Of course, pension funds, nonprofit institutions, and individuals are not subject to regulation by the Secretary of HUD or any other federal supervisory agency insofar as lending operations are concerned. The power of the Secretary to direct "all other holders" of mortgages than those under federal supervisory agencies to take actions required in the bill should be clarified. There should also be clarification that the Secretary could exercise the necessary power with regard to secondary market mortgage holders, such as FNMA and FHLMC.

Section 704(f) provides that the Secretary may make such determinations and accept such certifications with respect to the processing of guarantees provided under this title as he determines appropriate. Furthermore, under Section 704(e) a guarantee of any loan is precluded if the Secretary determines that it bears an interest rate or fee that is excessive. However, Section 705 mandates that a guarantee under this title shall be provided by the Secretary upon certain certifications that the loan meets three statutory requirements. There would seem to be a conflict between Section 704 and Section 705. Unless the Secretary, by regulation, establishes uniform interest rates and fees, perhaps with the interest rate subject to change from time to time, there really could not be any automatic guarantee.

It would be appropriate for the statute to give the Secretary more guidance as to the levels of fees and interest rates that may be charged. This question is particularly significant because of the mechanics to be used under the proposed program. The entire loan amount would be placed in an interest bearing escrow account from which payments would be made monthly for principal, interest, and other necessary costs of homeownership. The mortgagor would bear a cost in addition to the regular mortgage payments, the cost of the "spread" -- the difference between the rate of interest earned on the escrow account and the amount of interest required to be paid on the guaranteed loan. The determination of any fees and the appropriateness of the interest paid on the escrow account would be most important to protect the mortgagor against an unduly large cumulative debt resulting from excessive fees and "spreads" that may be involved in the operation. The law should encourage the Secretary to see to it that such costs to the borrower are held to a minimum insofar as possible.

Finally, the proposed title provides for an aggregate amount of guarantees outstanding in the amount of $750 million. It is strongly urged that there also be provided $100 million in budgetary authority for loans and payouts of such loans on behalf of unemployed tenants facing eviction.

Federal National Mortgage Association

In 1968, the Federal National Mortgage Association was changed from a federal to a private corporation by an act of Congress, commonly referred to as the FNMA Charter Act. From that time through 1980, FNMA had positive earnings and paid dividends to shareholders each year, generally increasing them. In 1981 and 1982, as a result of the historically high interest rates that it had to pay on borrowed funds, FNMA sustained losses; but in the first quarter of 1983, it again showed a profit.

FNMA is now proposing legislative changes designed to permit its engagement in new types of activities that presumably would reduce its vulnerability during high interest rate periods. However, there are also other implications of the proposed legislation.

The Federal National Mortgage Association has provided important support for the residential mortgage market and construction to help meet the country's housing needs. FNMA's support of housing has been in accordance with the spirit of Section 309(h) of the FNMA Charter Act. That section gives the Secretary of HUD general regulatory power over FNMA and assures that power by providing that "no stock obligation, security, or other instrument shall be issued by the corporation without prior approval of the Secretary." It also provides that, "The Secretary may require that a reasonable portion of the corporation's mortgage purchases be related to the national goal of providing adequate housing for low- and moderate-income families, but with reasonable economic return to the corporation."

As a quid pro quo for FNMA's assigned mission to help meet low- and moderate-income housing needs and the HUD Secretary's accompanying regulatory powers, several other provisions of the 1968 Charter Act give FNMA valuable advantages. Perhaps most valuable is FNMA's authority to borrow from the U.S. Treasury, at the discretion of the Secretary of the Treasury, up to $2¼ billion. This backstop, although now equal to only about 3 percent of FNMA's $70 billion of borrowed funds, makes the FNMA obligations highly marketable and saves it millions of dollars per year.

FNMA is also exempt from all taxation by any state or local government except for real estable taxes. It can conduct business without regard to any qualification statute in all states and possessions of the U.S. Federal Reserve Banks act as Fiscal Agents of FNMA. Obligations issued by FNMA are "exempt securities" under laws administered by the SEC, and their sale does not have to be conducted in accordance with SEC regulations. The Charter Act provides that all obligations issued by FNMA are lawful investments for and may be accepted as security by all fiduciary, trust, and public funds whose investment or deposits are under authority of the United States or any of its offices or officers. Investment in FNMA obligations is authorized for various types of federally chartered depository institutions.

FNMA obligations are eligible for purchase by the Federal Reserve in its open market operations, which provides market support for FNMA obligations. Furthermore, repurchase agreements on FNMA obligations by banks are exempt from Federal Reserve reserve requirements, similar to the treatment accorded obligations of, or obligations fully guaranteed by, the U.S. government, which also enhances the value of FNMA obligations.

In the legislation being proposed, none of the aforementioned and other advantages that FNMA enjoys under the law would be changed, but there would be significant changes affecting the obligation of FNMA to use part of its resources to finance low- and moderate-income housing. Thus, one of the FNMA proposals is to permit it to purchase up to 20 percent of its annual total of mortgage purchases in the form of home mortgages with no limits as to mortgage amount. This would mean that one-fifth of its mortgage purchase resources could be devoted to unlimitedly high-priced homes, a move away from support for low- and moderate-income housing. To the extent that FNMA is now precluded from purchasing relatively moderate-income housing mortgages in high-cost areas, the law could be amended to permit FNMA to purchase mortgages in areas that HUD has designated as high-cost areas within limits for FHA-insured mortgages that have been established for such areas.

Another proposed legislative change would be to permit FNMA to purchase nonresidential mortgages serving the needs of residents of subdivisions, neighborhods, housing projects, or other residential areas in an amount up to 10 percent of annual secondary mortgage market purchase activity. In order to keep such activity within bounds of the stated purpose to be served, it should be confined to consumer shopping, health, and recreational facilities.

Then, there are several proposed amendments that, in their combined effect, would greatly reduce the regulatory power of the Secretary of HUD and the U.S. government over FNMA. These include the following: (1) Expanding the FNMA Board of Directors from 15 to 18 by adding three more shareholder-elected directors, diminishing the influence of five directors that are appointed by the President; (2) the regulatory power of the Secretary of HUD would be diluted by reducing his power to require FNMA to make such specific reports on its activities "as he deems advisable" through elimination of the quoted phrase; by requiring that FNMA should directly report to the Congress as well as the Secretary by April 30 of each year and the Secretary would then report to the Congress by June 30 on FNMA activities and the FNMA report of April 30; (3) also eliminated would be the required approval of the Secretary of HUD to purchase mortgages with amounts in excess of certain statutory limits, and which would remove control by the Secretary over rental property mortgage amounts and rents to be achieved where there is local tax abatement, directly affecting the Secretary's capability to see that FNMA is helping to fulfill low- and moderate-income housing needs; (4) the heart of the Secretary's regulatory power over FNMA would be cut out by eliminating the requirement for his prior approval before FNMA could issue non-convertible debt obligations.

All of the aforementioned proposed amendments to dilute the regulatory powers of the Secretary of HUD should be rejected.

Senator **Heinz**. Mr. Schechter, thank you very much. Your entire testimony will be made part of the record, without objection.

Of course, there is nobody here to object.

First—I have some questions, don't worry—I want to thank all of you, because I would characterize your testimony as extremely supportive of what we are doing in the Senate Banking legislation.

The purpose of this hearing, as originally agreed to by Senator Tower, was to discover if there were any major shortcomings, any major impediments, any major problems with the Heinz-Riegle title to the Senate Banking Committee housing bill.

What you have all said, in effect, with the possible exception of Mr. Schechter, is that the legislation is pretty good. Mr. Schechter would like to see it go further. He hasn't explicitly stated how he would like to see it go further, but he is quite complimentary of it, if I may characterize him, because in his opening statement he said that it is a welcome approach, for which Senator Riegle and I thank you, Mr. Schechter.

I do want to therefore note for the record that this hearing, indeed, will be of great assistance to the committee in pressing ahead for the enactment of this legislation.

It may be we can structure some improvements to make the legislation work still better, but I, for one, am extremely gratified at the testimony we had from you, and, frankly, I was encouraged by what Mr. Kendall had to say with regard to the practicality of the legislation.

ACTION HOUSING FUND

Mr. Swanson, in Action Housing you have a fund which you hope to use to assist homeowners facing foreclosure by their lenders. Are you, in Action Housing, taking a gamble that other lenders won't touch?

Mr. **Swanson**. Principally, what we are doing is, after we work through a process involving housing counseling, lender forbearance, and the Federal mechanisms, and working with lenders in the community, if none of those things work then what we do is look at the loan and see if a modest amount of a loan, usually in the $2,000 range on an annual basis, can prevent foreclosure.

And if it is, in fact, foreclosure related to unemployment, if that is the case, our loan committee, which involves three private lenders and two public officials, would make the loan.

So the answer to your question is "yes."

Senator **Heinz**. That you are taking a gamble?

Mr. **Swanson**. We are taking a gamble, yes.

Senator **Heinz**. Mr. Rockwell, do I understand that Dollar Savings Bank and other lenders make donations to the fund?

Mr. **Rockwell**. The majority of the mortgage lenders of Pittsburgh have contributed to the fund, and Dollar Savings Bank has, yes.

Senator **Heinz**. Why do you make that kind of donation instead of directly assisting a borrower or homeowner?

Mr. **Rockwell**. The donation is modest, compared to the necessary funds that would have to get out. I believe the Action Housing Fund is approximately $200,000 total.

Senator HEINZ. You mentioned using housing opportunities in order to perform credit counseling, Mr. Rockwell, which is a provision included in our legislation.

What proportion or percentage of borrowers receiving counseling work out their problems without losing their home?

Mr. ROCKWELL. It is really too new to come up with a firm set of numbers on that, but we have had right now approximately 25 to 30 borrowers who are in active counseling. I have one in some of the examples I have here that will be referred to Action Housing, to Mr. Swanson's fund.

Senator HEINZ. Very well.

Mr. Prior, can you see any circumstances, even hypothetical circumstances, under which your institution might be forced to turn someone away who had a reasonable chance of getting back on their feet financially?

Mr. PRIOR. No. I refer you to our written statement and the 1975 draft of our policy—which, by the way was a revision of a still earlier policy. We are a very old institution, and we have traditionally had a slow loan policy that works generally along the lines of the statement that I have filed.

Many people find incredible the forbearance that my institution shows, but as long as there is any human possibility that the borrower with our assistance can rescue himself, we do everything we can to keep him in his house, sometimes even beyond its appraised value by the time we have capitalized payment of taxes, insurance, and some essential maintenance, because some of these people have never missed a payment on anything in their lives and would not but for their unique circumstance, brought on mostly by the travails of the automobile business, and we know they are a good gamble.

Some of your bill suggests some forbearance, that the regulated bodies be encouraged to let us show the forbearance we are disposed to show, and we find that attractive in your bill.

Senator HEINZ. Let me ask you this: Why would institutions, say in Pittsburgh or Pueblo, Colo., have some problems, I know they have got closed mills there—that kind of problem in extending forbearance?

Mr. PRIOR. It is largely a perception of the local economic circumstance. We are a rural area and are not confronted with some of the problems that our brethren in the metropolitan areas are compelled to confront.

Senator HEINZ. So where there is a high incidence of unemployment there are some real problems with the lenders, is that right?

Mr. PRIOR. Indeed, there are.

Senator HEINZ. Could you explain on their behalf the kind of problem they have confronted?

Mr. PRIOR. Yes. My institution lends to some limited degree in Indianapolis, Ind., although we are situated 50 miles east of Indianapolis, out in the country, so to speak.

In some neighborhoods of Indianapolis, it is sometimes very difficult for me to be able to say we will carry that property, with no more risk than we will one that is located in my home community of New Castle, for example, because risks of vandalism are much higher. When high unemployment sets in in the large city areas, neighborhood deterioration appears to have its way more rapidly than with property in the rural areas.

Senator HEINZ. What I hear you saying is that in trying to make that difficult decision between protecting the borrower and protecting the depositor in areas where there is a high incidence of unemployment, in effect, you tend to have to look out more for the interests of the depositor, and therefore the borrower is going to be less able to be protected?

Mr. PRIOR. It is always, Senator, an evaluation of risk to the institution. It is not altruistic in total.

When we—for example, as I said a minute ago——

Senator HEINZ. Let the record show that I don't know of any member of this committee that has ever accused a bank, or even an S&L, of being altruistic. [Laughter.]

Mr. PRIOR. I might say that is very perceptive. [Laughter.]

Senator HEINZ. Very well.

Mr. Rockwell, are you experiencing, or do you foresee a time when you would just have to turn people with a good credit history away and say, "I am sorry, we are going to be forced not to carry you any longer"?

Mr. ROCKWELL. You may reach that point, but I can't see that you would ever reach a point initially where you would say, "Look, we just can't forbear on you."

I can see that you could get to a point where there is just no hope of reconciliation; something is going to have to happen.

Senator HEINZ. Mr. Swanson, do we have people in Pittsburgh right now who have had good records but are having difficulty being forborne—if that is the right word?

Mr. SWANSON. I would say without a doubt. In fact, the first loans that we have made and the 25 we have pending are all unemployed mortgagors who have used every means. In some cases, lending institutions have been forbearing for 12, 16, 18 months, and it is not a tenable situation anymore.

So they are applying for assistance, and one of our criteria for the loan committee is to work out a plan of stability for 24 months before we make the loan, and we make those types of decisions.

But that is definitely occurring now in Pittsburgh, and our major concern is—with our unemployment rate the way it is for as long as it has been that high—that the rate of activity is going to accelerate tremendously.

Senator HEINZ. Mr. Schechter, I take it you would agree that if lenders were willing to extend forbearance to any homeowner, if he or she could pay his or her mortgage in full, there wouldn't be need for a Federal program. Would you agree with that?

Mr. SCHECHTER. Yes.

Senator HEINZ. But as we've heard, there are some other factors here, where it becomes at a certain point impractical to expect that to happen.

Let me ask you this. Is there any reason to establish a program under which lenders or the Federal Government are compelled to give the distressed homeowner a better break then they get under normal circumstances?

Mr. SCHECHTER. I would say, from the point of view of broad national interest and in the interest, perhaps, of the lenders themselves, because what happens is, we begin to get more foreclosures in an area of high unemployment. The entire market for the real estate collapses, and we get, in a sense, a self-fulfilling prophecy that this area is just going downhill, because more and more people will have to leave, to the extent that also some unemployed renters, perhaps, have to start living in the parks, and so on. It becomes a situation where people may not want to buy homes, and we've had that in some cities. So I do think—although I wholly support title VII of the bill, I think we need it now, but we have to look beyond that.

And if I might go back for a moment to the Great Depression, when we got something called the Homeowners Loan Corp., which was formed because we had hit a volume of about 230,000 mortgages, homes being foreclosed per year and the spreading effect I was describing was taking place. So the Homeowners Loan Corp. took mortgages over from financial institutions that were holding them. The financial institutions couldn't hold them anymore.

They made arrangements with the homeowner to greatly reduce the payments that were required. Anything the person could pay was what it amounted to. Just a few dollars a month to keep some sense of responsibility for it, and the Homeowners Loan Corp. carried that program out for a number of years and showed a profit on its books, incidentally. They also had to foreclose some homes eventually. But I do think as long as we are relying on the individual financial institution to bear the burden, they will be reaching a point as indicated in Pittsburgh, where they probably can't go on.

Senator HEINZ. Let me ask you this, Mr. Schechter. If the Government supplied direct loans to the unemployed renters, what collateral should be required? Private renters now?

Mr. SCHECHTER. There is no collateral probably they can require. Probably, it would be a matter of looking at the person's record and either we make the assumption that these people will never work again which, as I say, becomes a self-fulfilling prophecy, because they then have to move. We know with people who have gone to Texas, who are living with their families.

Senator HEINZ. So-called black bag people.

Mr. SCHECHTER. Yes. If we allow that to happen, we are doing the economy a disservice, as well as the entire approach.

USE OF COINSURANCE

Senator HEINZ. Let me ask Mr. Prior. Mr. Prior, Mr. Schechter indicates that the 10-percent coinsurance may serve as an impediment. Do you see the need to lower it to 5 percent?

Mr. PRIOR. I don't know that I do. I think we support that provison of the bill. I have no problem with that.

Senator HEINZ. Senator Tower suggested in our markup—he withdrew the actual amendment and didn't press it—that raising the coinsurance to 25 percent, would that be too high.

Mr. PRIOR. It might be.

Senator HEINZ. Would you have to apply a different standard in deciding who gets assisted at 25 percent and at 10 percent?

Mr. PRIOR. I suppose in applying standards, I come back to my original response to you a few moments ago. It is an evaluation of risk, and it's very hard to write precise rules on that. I guess my concern about this whole program is more that you have no way of doing it, other than to write rules. And yet, Senator, these circumstances are absolutely individual. And it's very difficult to say what is appropriate in this case and what is appropriate in that case.

I think that is a dilemma.

Senator HEINZ. I think that's a very important and valid point, and as you yourself stated in a different context earlier, the differences among specific areas are such that the behavior of lending institutions may vary, which can be, in many respects identical institutions, the same kind of capitalizations, the same kind of portfolio. It may be very different, depending on the fortunes of the area which it serves.

One of the difficulties we have had, though I think we're overcoming it, in getting legislation like this out of this committee and, hopefully, to the floor for favorable action is, it is not entirely clear to every one of our colleagues that there are sometimes small pockets and sometimes large pockets, depending on the State, much more obvious, obviously, in a State like Pennsylvania, Michigan, northwestern Indiana, in particular, up near Gary, where the so-called normal rules aren't working too well.

And I think all of you have made a very substantial contribution to helping the committee and our other colleagues understand that very basic issue here.

Unless you have any further comments—Mr. Schechter.

Mr. SCHECHTER. I'd just like to say on that 10-percent versus 5-pecent loss ratio, not all lenders are alike in their standards too. Mr. Prior has a long history of being forebearing and going with the borrower. Other lenders may not. And the difference between 10-percent and 5-percent risk might be the marginal factor in going along with a case like that.

Senator HEINZ. That point is noted and will not be forgotten.

Mr. SWANSON. If I may, I would just like to support Mr. Schechter's observation that there is tremendous variation between lenders, and as one who would probably expend a fair amount of time trying to convince lenders to participate, if you and Senator Riegle's proposal becomes law, I wouldn't want to see a lender ever fail to participate, because if that were an objective for some, I suspect maybe a small number of lenders, but there will be some who would find that a problem.

I certainly think that the 25 percent would be a problem for some lenders.

Senator HEINZ. As do I. Are you suggesting that the 10 percent is too high and it should be lowered to 5?

Mr. SWANSON. I'm saying that I think that 5 percent would probably help convince some lenders to participate.

Senator HEINZ. Thank you very much, gentlemen. Thank you very much for your testimony and for your very good answers to questions. We appreciate all your help.

The hearing is adjourned.

[Whereupon at 4:20 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

MORTGAGE PASSTHROUGHS: STRUCTURE AND POLICY

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This study was commissioned by the Mortgage Insurance Companies of America (MICA) with the understanding that I was free to express my own views. MICA may not necessarily endorse the views expressed. I am grateful to Steven Doehler, Staff Vice President of MICA, and to Edward Elles of the Federal Home Loan Mortgage Corporation for many helpful suggestions.

Jack M. Guttentag

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This paper divides broadly into two parts. Sections I-III are largely descriptive, covering the economic rationale of passthroughs, the preferences of lenders and investors regarding specific passthrough characteristics, and the characteristics of the passthroughs now available in the market. Sections IV-VIII are policy oriented and consider alternative strategies for meeting the overall demand for passthroughs while encouraging the development of competitive market structures.

I. THE ECONOMIC RATIONALE OF PASSTHROUGHS

A mortgage passthrough certificate represents a beneficial interest in a specified pool of mortgages or participation interests in mortgages. The basic features of the passthrough instrument were established by GNMA in 1970. The dollar balance of the mortgage (or participation interests) in a specified pool is identical to the balance of the passthrough instrument. As the balance in the mortgage pool is paid down by scheduled payments of principal and interest and by prepayments, the balance of the passthrough is paid down correspondingly as the payments are "passed through" to the certificate holder. The due date on the funds passed through, however, is some specified period after the payment date on the mortgages. On GNMAs and some other passthroughs the regular installment payment is paid on the due date by the issuer regardless of whether or not it has been received from the borrower. Prepayments are passed through as received, subject to the same delay as the installment payment. The commitment of timely payment may be supported by various types of insurance.

The basic purpose of passthroughs is to improve the transferability of mortgages. Passthroughs would not be needed if all mortgages were retained in the portfolios of originators until they were paid off. Historically most conventional mortgages have, in fact, been retained. Since about 1966, however, the ability of the major portfolio lenders (thrift institutions) to attract savings has declined and the demand for efficient methods of transferring ownership has correspondingly increased.

Passthroughs are more readily transferable than mortgages for a number of reasons. First, because of payment insurance, investors without the capacity to assess mortgages can acquire passthroughs with very small risk. Second, the cost of double surveillance and risk assessments, always present to some degree in purchases of whole loans, are largely eliminated.[1] Third, recordkeeping costs of investors are sharply reduced. Fourth, passthroughs may prove to be more marketable after initial sale than whole loans, thus providing investors with a more liquid asset.

On the other side of the ledger are special costs associated with passthroughs. The purchase of a claim against mortgages, rather than the mortgages themselves, introduces an added risk to the investor, which must be neutralized by adding other features to the transaction—at a cost. A trustee-custodian may be needed to protect investors against fraud, procedural deficiencies, and the like. To reduce investor uncertainty regarding payment of principal and interest, issuers may assume responsibility for advancing delinquent mortgage payments out of their own resources, which is costly and requires backup insurance. Since passthroughs may be sold to non-mortgage lenders, a new distribution mechanism is required to reach such investors. Other costs may be associated with a particular type of instrument. Passthroughs become economically justified when the yield concession investors are prepared to accept relative to whole loans, because of reduced risk and greater marketability, exceeds these passthrough costs.

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[1] See Jack M. Guttentag, *Changes in the Structure of the Residential Mortgage Market: Analysis and Proposals*, Federal Home Loan Bank Board (Washington, D.C.: Government Printing Office, 1970), pp. 15-33.

Passthroughs are sometimes viewed as a hybrid instrument having some of the characteristics of bonds and some of the characteristics of mortgages. They are similar to bonds in being available in large denomination and in carrying regular interest (coupon) payments. They are similar to mortgages in that payments are monthly rather than semi-annually or annually, and include principal repayments as well as interest. Passthroughs cover a narrower range of default risk than bonds, running from riskless GNMAs (which carry a full faith and credit guarantee of the Federal Government) to conventional passthroughs rated AA by Standard and Poors. Bonds range from riskless Treasury issues to very low grade and speculative issues.

II. SUMMARY DESCRIPTION OF EXISTING PASSTHROUGHS

We can distinguish seven types of passthroughs: GNMA mortgage-backed securities (henceforth GNMAs); conventional mortgage-backed passthroughs sold directly by lenders, or through conduits (henceforth PTs and PTCs); Federal Home Loan Mortgage Corporation (FHLMC) Mortgage Participation Certificates sold by FHLMC, or by lenders who obtain the Certificates through a Certificate-mortgage swap with FHLMC (henceforth PCs and PCs*); and Federal National Mortgage Association (FNMA) mortgage-backed securities sold by lenders, with the mortgages pooled by FNMA from a group of lenders, or from a single lender (henceforth FNMAs and FNMAs*). PCs*, FNMAs and FNMAs* appeared only toward the close of 1981.

To illustrate how these passthroughs are structured some definitions will be useful. The "packager" is the party that owns the mortgages that are transformed into passthrough "certificates," which are the passthrough claims. The "lender," if not the packager, is the party from whom the packager acquires the mortgages, who also services the mortgages in the pool. The "issuer" (sometimes called the "pool administrator") is the party assuming the primary responsibility to make payment to the "investor," who in turn is the party holding the certificate. The "seller" is the party who markets the certificate to the investor.

Four procedures can be distinguished by which mortgages are transformed into passthrough certificates:

1. The lender, packager, issuer and seller are all the same party. This is the case with GNMAs and PTs. The lender packages the mortgages, issues the certificates and sells them in the market.

2. The lender sells the mortgages at market price to a conduit, who in turn packages them, and issues and sells the passthrough certificates. This is the procedure used in the case of PTCs and PCs. It differs from procedure 1 only in the prior sale of the mortgages to FHLMC or to a private conduit, thus allowing for marketing on a larger scale.

TABLE I
SUMMARY OF PRINCIPAL CHARACTERISTICS OF PASSTHROUGHS

	GNMAs	PTCs	PTs	PCs	PCs*	FNMAs	FNMAs*
1. Packager	Lender	Conduit	Lender	FHLMC	Lender	Group of Lenders	Lender
2. Issuer	Lender	Conduit	Lender	FHLMC	FHLMC	FNMA	FNMA
3. Seller	Lender	Conduit	Lender	FHLMC	Lender	Lender	Lender
4. Mortgage Insurance	FHA, VA or FMHA	Private Mortgage Insurance When Loan-Value Ratios Exceed 80%					
5. Payment Insurance	GNMA	Conduit	Lender	FHLMC	FHLMC	FNMA	FNMA
6. Minimum Pool (Millions)	$1	Public $25, Private $5		$50	$5	None	$1
7. Access to Market	Lender	Conduit	Lender	FHLMC	Lender	Lender	Lender
8. Liquidity Scale	100	Public-10 to 20 Private-5		50	50	?	?
9. Provision of Information	Some			Least		Most	
10. Payment Delay	15 Days	25 Days		45 Days		25 Days	
11. Range of Coupons	One Rate	No Limit			2.00 Pts.	2.50 Pts.	
12. Servicing Fee (Basis Points)	44, Fixed	25 Minimum		37.5 Minimum on Whole Loans; Zero Minimum on Participation		25 Minimum	
13. Payment Insurance Premium (Basis Points)	6, Fixed	Negotiated		Variable, set in auction		25 or 35, Fixed	
14. Maximum Loan, One Unit (Thousands)	FHA $67.5 VA $110.0	About $250		$107.0			
15. Maximum Age of Mortgage (Years)	1	No Limit				10	

TABLE II
RESIDENTIAL MORTGAGE-BACKED PASSTHROUGH CERTIFICATES ISSUED
(Millions)

		PTs and PTCs					
Year	**GNMAs** (1)	**Publicly Offered** (2)	**Privately Offered** (3)	**PCs** (4)	**PCs*** (5)	**FNMAs** (6)	**FNMAs*** (7)
1970	$ 452	$ —	$ —	$	$ —	$ —	$ —
1971	2,702	—	—	67	—	—	—
1972	2,662	—	—	494	—	—	—
1973	2,952	—	—	317	—	—	—
1974	4,553	—	—	52	—	—	—
1975	7,447	—	—	526	—	—	—
1976	13,764	—	—	1,456	—	—	—
1977	17,440	225	—	4,834	—	—	—
1978	15,358	728	44	5,630	—	—	—
1979	24,940	446	594	3,878	—	—	—
1980	20,649	233	360	2,425	—	—	—
1981	13,653	NA	NA	1,138	5,314	250	3,000

NA: Not Available

Sources:

Col. 1: HUD
Cols. 2 and 3: *Report of the Task Force on Savings and Loan Profitability*, July 1981.
Cols. 4 and 5: FHLMC
Cols. 6 and 7: FNMA

3. The lender packages the mortgages and sells the certificates but another party issues them. This is the procedure used with PCs* and FNMAs*, with FHLMC and FNMA being the issuers. Where procedure 2 centralizes the marketing function, this procedure centralizes the issuance function.

4. The mortgages owned by a lender are combined by the issuer with those of other lenders to create a larger pool. The certificates are then sold by the individual lenders. This is the procedure used with FNMAs, and it is identical to procedure 3 except for the additional function assumed by the issuer of combining the mortgages held by several lenders into a larger single certificate issue.

The first three lines of Table I relate the functional definitions to the seven types of passthrough discussed in this paper.

As shown in Table II, GNMAs have accounted for the largest share of passthroughs to date. The rapid growth of GNMAs was facilitated by their almost immediate acceptability by investors, reflecting the unconditional payment guarantee of the Federal Government. While starting about the same time as GNMA, FHLMC's PC program has been slower to develop and has been running about one-fifth the size of the GNMA program. The new PC* program, in contrast, has generated extraordinary interest in a very short time. In just the last quarter of 1981 $5.3 billion of certificates were sold.[2] The PT and PTC programs began in 1977 but they have been severely handicapped relative to the other programs (see below) and their volume so far has been small. The new FNMA programs were just getting started in late 1981.[3]

III. PASSTHROUGH CHARACTERISTICS AND MARKET NEEDS

In this section I will discuss in general terms each of a number of passthrough features that affect lenders and investors, and then consider how the feature is provided on the existing instruments.

A. *Insurance*

Broadly, passthroughs carry insurance on the individual mortgages in the pool, and supplementary insurance designed to support the issuer's commitment to make timely payments.

Passthrough insurance is of crucial importance to investors. The quality of insurance affects the degree of confidence investors have that they will not lose principal in the event of mortgagor default, and that there will be no delay in transmission of the payment to them in the event of mortgagor or servicer delinquency. The quality of insurance also importantly affects the marketability of passthroughs.

1. Sufficient insurance. If investors are prepared to depend on passthrough insurance fully in the sense that they disregard the identity of the seller and the

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[2] Under the FNMA programs and FHLMC's PC* program, certificates are issued in the first instance to lenders in exchange for loans, a procedure sometimes referred to as a "swap." Subsequently the lender may market the certificates to investors. Hence, issue volume data for these programs are not comparable to those covering the other programs under which issuance is equivalent to placement with investors. No data exist on subsequent sales of these new passthroughs to investors.

[3] The FNMAs sold in late 1981 were sold by FNMA rather than by lenders, in the fashion of FHLMC with PCs. This is viewed by FNMA as a transition to the new procedure.

characteristics of the mortgages in the pool that bear on default and delinquency risks, the insurance can be said to be "sufficient."

Sufficient insurance generates a number of important passthrough attributes. First, it reduces fixed pool costs. If insurance is sufficent issuers need not bear the costs of demonstrating their financial strength, that the mortgages in the pool carry low default and delinquency risk, and that procedural arrangements to prevent fraud are solid. With low fixed pool costs, small pools are economic. And this means that small originators can have direct access to the market.

Second, sufficient insurance increases the substitutability of one pool for another. Since there is no default or delinquency risk on any pool, all are homogenous in this regard. (Sufficient insurance, however, does not create homogeneity with regard to coupon rate and cash flow characteristics.) Pool homogeneity means greater marketability, even of small pools, which is also important to small originators.

A third useful attribute of sufficient insurance is that it provides a uniform passthrough instrument that serves as a pricing benchmark for all other passthroughs and whole loans. In this respect sufficient insurance improves the efficiency of the entire mortgage market.

Finally, if passthroughs carrying sufficient insurance become quantitatively important, efficient secondary markets as well as forward and futures markets will develop, which improves the efficiency of the entire capital market. Efficient secondary markets keep bond yields in line with mortgage yields, for example, while forward and futures markets allow financial institutions of all types (including non-mortgage lenders) to hedge against interest rate risk.

To date, the only passthrough insurance considered sufficient by the market has involved a Federal full faith and credit commitment (under GNMA), or insurance by Federal agencies (FHLMC and FNMA) that is not full faith and credit but is viewed by the market as almost as good. The acceptability of private insurance depends upon the financial soundness and integrity of the particular insurer. The acceptability of such guarantees has increased over the years but they are not yet viewed as sufficient.

2. Insurance on existing passthroughs. In all seven types of passthroughs the individual mortgage loans in a pool carry the usual homeowner's insurance policy against standard hazards. On GNMAs, mortgages are insured by FHA, VA or FMHA. On all others, private mortgage insurance is required on mortgages carrying loan-value ratios exceeding 80%. PTs and PTCs, in addition, require special hazard insurance in an amount normally equal to 1% of the initial pool balance to cover risks not covered by individual homeowner policies, and pool insurance in an amount normally equal to 5% of the initial pool balance to cover losses from defaults. Other arrangements providing comparable safety to investors can be substituted, including letters of credit (adopted by the Bank of America) and subordination arrangements wherein the cash flows on a portion of the pool are placed in a reserve account to cover losses on the remainder of the pool (the method adopted by Home Savings and Loan Association and Crocker National Bank).[4]

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[4] Also, PT issuers with a low credit rating on their unsecured debt may improve the rating of their PTs by purchasing servicing-performance insurance, which guarantees the issuer's performance as servicing agent.

On GNMAs, FNMAs, and FNMAs* the timely payment of the monthly installment is guaranteed by GNMA and FNMA, respectively. FHLMC guarantees the timely payment of interest on PCs and PCs*, and also guarantees that the investor will not lose any principal, but it does not guarantee timely payment of principal. On PTs and PTCs, issuers normally state an intention to make timely payment of principal and interest, but any advances of the issuer's funds required to meet this intention ordinarily are limited to amounts reimbursable under pool insurance contracts.

GNMA's payment guarantee is a full-faith and credit obligation of the Federal government. The guarantees of FNMA and FHLMC are not full-faith and credit, although both agencies are quasi-public institutions that are viewed by the market as involving an implicit if ambiguous Federal obligation. FHLMC's payment obligation has been accepted by the market as sufficient and presumably FNMA's will also, although a yield premium is required above the yield on GNMAs. The FHLMC and FNMA guarantees will be discussed later.

B. Pool Size

Pool size is important to both originating lenders and investors. Other things being equal, originators prefer small pools because they reduce interest rate risk. This is especially true of mortgage bankers for whom the risk of adverse price change during the period of inventory accumulation is a major hazard. Portfolio lenders who are free to pool mortgages from their portfolio do not have quite the same degree of preference for small pools.[5] When yield curves are downward sloping, furthermore, carrying inventory in preparation for pooling is a loser and being able to sell small pools reduces such losses. While small pools are ordinarily more costly because of fixed pool costs, with sufficient insurance, fixed costs are small and this disadvantage of small pools carries little weight.

Investors tend to prefer large pools, for two reasons. The first is that certificates issued against large pools tend to be more marketable—unless sufficient insurance makes pools interchangeable in terms of default and delinquency risk, in which case marketability is not affected by pool size. The marketability problem is discussed further below.

A second reason why investors may prefer large pools is that the cash flow characteristics of large pools are better defined because prepayment patterns are more stable and predictable. The "law of large numbers" works with large pools.

Stability is important only to small investors who can only acquire interests in one or a few pools. Large investors can obtain the stability in principal recoveries of large pools by acquiring interests in many small pools.

Predictability of principal recoveries, in contrast, may be a valued attribute. In general, when passthroughs are acquired at a discount (premium), investors prefer (and will pay more for) passthroughs with a high (low) expected termination rate, because the earlier recovery of the discount (delayed payment of the premium) will increase the realized yield.[6] The predictability of cash flow patterns on large pools is better than on small pools, especially if investors have access to information on the characteristics of mortgages in the pool which bear on termination rates (see below).

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[5] In the short-run portfolio lenders can shield themselves from the effects of price changes on current income by retaining mortgages in their portfolio at acquisition value, a privilege that mortgage bankers do not have.

[6] This is not always true, however. If investors acquiring passthroughs at a discount expect interest rates in the future to drop well below the contract rate on the mortgages underlying the passthroughs, they may prefer slow paydown passthroughs because retention of the higher contract rate will more than offset earlier recovery of the discount.

The exercise of a market preference for large pools because they have more predictable cash flow characteristics presupposes an ability by the investor to assess and evaluate the cash flows on specific passthroughs in the light of the investor's own portfolio needs. This implies a degree of sophistication that not all institutional investors today possess.

By regulation, GNMA pools can be no smaller than $1 million, $500,000 in some cases, and because fixed pool costs are low and the market can be accessed with small pools, few GNMA pools exceed $5 million.

Because of high fixed pool costs, PT and PTC pools have been larger than $25 million when publicly offered, while most private placements have been larger than $5 million.

Most PC pools are above $100 million, for administrative convenience as well as cost savings.[7]

PCs* and FNMAs* by agency policy are subject to minimum pool sizes of $5 million and $1 million respectively, and since pool costs are low in both cases lenders are likely to favor small pools as they do with GNMAs, at least for newly originated mortgages. Since old mortgages are eligible for pooling under these programs, however, large institutions may find it convenient to create large pools out of their portfolios.

FNMA will probably follow the practice of FHLMC on PCs in creating large pools of FNMAs in order to minimize costs.

C. Marketability: Primary Market Access

The marketability of passthroughs by original owners of mortgages must be distinguished from their marketability by subsequent holders. The first type of marketability I will term "primary market access" and it depends entirely on insurance and issue size. Where insurance is sufficient any lender meeting the requirements of the issuer and/or guarantor has direct access to the primary market. If insurance is not sufficient, small pools are uneconomic and small lenders can access the market only through conduits that buy mortgages from large numbers of lenders and combine them into pools of substantial size.

Lenders have direct access to the market under all the existing programs except PCs and PTCs where FHLMC and private conduits access the market.

D. Liquidity

The marketability of an already outstanding instrument is usually referred to as its "liquidity." An instrument is liquid if it can be sold quickly, in substantial volume, at a price equal to its true value. In dealer markets, marketability can be measured by the prevailing spread that dealers maintain between the price at which they will buy and the price at which they will sell, and by the amounts that dealers are willing to commit themselves for in a given deal.

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[7] Because of lags in data transmission from servicing agents to FHLMC, the Corporation bases monthly principal payments to investors on estimates; discrepancies are adjusted in the following month. The estimates are based on "group factors" that are developed separately for each pool. Random variability in these factors is minimized by making the pools large. FHLMC has created a few small pools hand tailored to specified requirements of a single investor.

In general, securities are more liquid (a) the more homogeneous they are, especially with regard to default and delinquency risk, (b) the larger the volume and (c) given the volume, the greater the demand for ownership transfers. If the security is homogeneous, potential buyers need not incur significant information costs to assess risk. If volume is large dealers can find enough securities to hold, or can go short with confidence that they can quickly cover their needs. (The liquidity of an asset often will rise over time as volume increases.) If the demand for ownership transfers is large, dealers will find it profitable to make markets at small spreads.

Passthrough volume as a determinant of liquidity refers to the outstanding stock, but even more important is the volume of new issues because new issues tend to be more actively traded than old ones. The major reason is that old issues generally carry greater yield risk.

Yield risk is the risk that realized yield will differ from expected yield because the realized pattern of prepayments differs from the expected pattern. If a mortgage is purchased on the assumption that it will be prepaid in 12 years and in fact it is prepaid in 20 years the realized yield will be lower than the expected yield if the price was below par, and higher than the expected yield if the price was above par, the extent of the yield divergence depending upon the size of the discount or premium. Since the size of the discount or premium depends upon the contract rate on the instrument relative to the prevailing market yield, the greater the divergence between that rate and the current yield, the greater is the yield risk on the instrument. Hence, issues carrying rates well off the current market yield are not generally as marketable as those carrying rates close to the market. For this reason much of the secondary market activity in passthroughs is in new issues which carry rates close to the market yield.[*]

Liquidity is not a universal concern of lenders. At any given time some institutions value liquidity highly, others not at all, depending on their needs and the availability of alternative liquidity sources. The value placed on liquidity by the market, as measured by the yield differential between instruments that are identical in all respects *but* liquidity, sometimes termed the "liquidity premium," will depend on the relative importance of those in the market who value liquidity versus those who do not. Liquidity premiums can vary markedly over time, generally rising with market interest rates, as more and more market participants find their liquidity position strained. When liquidity premiums are high, illiquid types of passthroughs become more costly to issuers relative to more liquid types.

Because all GNMAs are homogeneous with respect to default and delinquency risk (although not with respect to yield risk), and because outstanding volume and new issue volume are substantial, GNMAs are the most liquid of the passthroughs. PCs and PCs* are also homogeneous but volume is much smaller than that of GNMAs and they are correspondingly less liquid. The volume of PTs and PTCs is considerably smaller and, worse yet, each PT issue is viewed by the market as a separate security because of potential differences in default and delinquency risk. The one important although partial exception to this is the issues of the Bank of America, which because of the financial strength of the issuer and the substantial homogeneity of the pools, tend to be more substitutable for each other than PTs of other issuers. Hence, the liquidity of Bank of America PTs is greater than that of other PTs.

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[*] Another major reason why low contract rate GNMAs and PCs are not actively traded is that many holders of these instruments are averse to taking the capital loss associated with their sale.

PTs or PTCs issued privately have very little liquidity. They are typically negotiated with a single investor who has little need for liquidity and who intends to retain the passthroughs until they are paid off. Such investors often specify the characteristics of the mortgages they wish in the pool, which may make the passthrough prima facie questionable to other investors, and since there is no floating supply dealers will not make a market in it. If the investor unexpectedly finds it necessary to sell the passthrough, his problem is little different from selling a package of whole loans. A quick sale would be possible only at a price well below their true value. To obtain the true value of the passthrough, the holder would be obliged to retain the services of a broker to canvass the market, a process that is likely to take some time.

Typically, dealer spreads on GNMAs range from one-eighth of a point on recently originated issues to one-fourth or higher on low coupon older issues which are not as widely traded. (When the GNMA program began spreads were about one point.) Recently issued PCs trade at dealer spreads of one-eighth to one-fourth ranging up to about one-half. PCs* may or may not trade on the same basis. On PTs the spreads may range from one-half to one point or higher, though Bank of America PTs fall somewhere between PCs and other PTs. As other measures of liquidity, repurchase agreements are much more likely to be written against GNMAs than against PCs, and much more likely to be written against PCs than against PTs. On an arbitrary scale on which the liquidity of GNMAs in 1982 is set at 100, PCs and PCs* would be rated at about 50, Bank of America PTs at 20, other publicly offered PTs or PTCs at 10 and private placements at 5. It is too early to make any judgments about FNMA-issued passthroughs.

E. Provision of Information on Pool Characteristics

If insurance is not sufficient, investors want information on the characteristics of mortgages that bear on default and delinquency risk. Sophisticated investors who prefer passthroughs with specified cash flow characteristics also want as much information as possible on the characteristics of the mortgages that are related to prepayment tendencies, since such data increase the predictability of cash flows.

Under all the passthrough programs the balance of the mortgages in a pool at the end of every payment period must be reported. Transactions and accurate accounting would be impossible without such information, since the balance of the passthrough is identical to the balance of the mortgages. Beyond this the provision of information on pool characteristics varies widely among the passthroughs. FHLMC provides some information on the characteristics of its total portfolio but nothing on individual PC and PC* pools except the issue date, maturity date and average contract rate which is reported only once a year. This is a matter of corporate policy, about which some questions can be raised (see the appendix note).[9]

On GNMA pools, information is available on the type of loan, the coupon rate, the identity and location of the issuer-servicer, the current holder, and the period remaining to maturity.[19]

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[9] As FHLMC shifts its operations toward that of a guarantor rather than a conduit, it is possible that the market will press for more information.

On PTs and PTCs a wide range of information on pool characteristics typically is provided, including distribution of loan balances by type and location of property and by rate. Some information is provided in the form of limits, e.g., "all loans have loan-value ratios less than 80%" or "individual loan amounts range from $30,000 to $150,000."

The most complete information is provided under the FNMA programs. FNMA provides investors with the following data on each pool.

Number of mortgage loans
Largest outstanding individual loan balance
Smallest outstanding individual loan balance
Average outstanding individual loan balance
Latest maturity date
Weighted average remaining term to maturity
Highest contract rate
Lowest contract rate
Weighted average contract rate
Number of loans and aggregate outstanding balance by year of origination
Number of loans and aggregate outstanding balance by type of security property (4 categories)
Number of loans and aggregate outstanding balance by original loan amount (4 categories)
Number of loans and aggregate outstanding balance by original loan-value ratios
Number of loans and aggregate outstanding balance by state in which security property is located

Thus, FNMA and FHLMC are at opposite ends of the pole regarding the provision of information. Other things the same, FNMA passthroughs potentially will be more attractive to investors interested in selecting pools with desirable cash flow characteristics.

F. Payment Delay

The delay between the time payment is due from the borrower (usually the first day of the month) and the time it is due the passthrough certificate holder affects the distribution of income between the issuer and the investor. The longer the delay, the lower the effective yield to the investor and the larger the positive float enjoyed by the issuer (payments received from borrowers before the certificate payment date). Since the impact of the payment delay is readily calculable by both parties, a longer (shorter) delay results in a correspondingly lower (higher) price for the passthrough.

The payment delays are 15 days on GNMAs, 25 days on FNMAs, FNMAs*, and PTs, and 45 days on PCs and PCs*. Thus, payments due from borrowers on the first day of the month are passed through to certificate holders on the 15th, 25th, or the 15th day of the following month, respectively. These delays are taken into account in the yield tables published by the Financial Publishing Company, which are widely used in the industry. For example, these tables show that a pool of 11% mortgages, acquired at par with prepayment in 12 years, yields 10.93% if it is a GNMA pool, 10.89% if it is a PT, and 10.79% if it is a PC. When acquired as whole loans, the indicated yield is, of course, 11%.[11]

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[19] Strictly speaking what is reported is the pool issue and maturity dates but since all mortgages in GNMA pools must be less than one year old this information provides a close estimate of the remaining maturity.

G. *Range of Coupon Rates*

Pools can be limited to mortgages covering a single coupon, to a limited range of coupons, or they can be completely open-ended. Broadly, investors prefer single coupon pools because it fixes the servicing fee and may increase the predictability of cash flows. Investors will accept a range of coupon rates if insurance is sufficient, or if the servicing fee on every mortgage in the pool meets the minimum level considered "safe." (This latter requirement assures that the overall servicing fee on the pool will never fall below the minimum if the high rate mortgages in the pool are prepaid, which implies that the servicing fee on the higher rate mortgages in the pool exceeds the minimum.)[12]

On GNMAs, only one contract rate is allowed per pool, FHLMC allows a 2.00% range on PCs* while FNMA allows a 2.50% range on both FNMAs and FNMAs*. On PTs and PTCs there are no limits but pooling a wide range of coupons involves some sticky technical difficulties.[13] No information is available on the range of coupon rates in PC pools.

H. *Servicing Performance*

Investors and insurers are very much concerned with the ability of the pool servicer to perform. Broadly, this concern can be met in three ways.

1. Demonstrated competence. Where investors or insurers depend strictly on demonstrated competence they must have information on the servicer's history, net worth, volume of business, references, etc. In general, demonstrated competence is necessary but not sufficient.

2. Profitable service fees. A way to assure servicing performance is to require a servicing fee large enough to be profitable. A profitable servicing fee protects the investor not only against loss associated with the issuer's insolvency but also against loss that could result from deliberate default by the servicer in the event that the servicing eventually becomes unprofitable.[14] The adequacy of a given servicing fee depends on (a) average mortgage size (it costs no more to service a large mortgage than a small one); (b) insurance premiums that the servicer is obliged to pay (or its counterpart in income lost on subordination ar-

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[11] This is somewhat misleading because the indicated yield on whole loans assumes that the installment payments are always received on the due date, usually the first day of the month. In practice, payments are often delayed, perhaps by 8-12 days on average. This reduces some of the indicated discrepancy between the yield on whole loans and the yield on passthroughs.

[12] See Jack M. Guttentag, "The Conventional Passthrough Market: Trickle or Flood?," in *Savings and Loan Asset Management Under Deregulation*, Proceedings of the 6th Annual Conference of the Federal Home Loan Bank of San Francisco, December 8-9, 1980, p. 286.

[13] See "The Conventional Passthrough Market," pp. 286-7.

[14] A high servicing fee provides assurance that the issuer will find servicing profitable over the life of the pool. Since servicing income per mortgage declines as the balance is paid down while servicing costs rise with inflation, pools become progressively less profitable to service over time. If at some point servicing costs exceed income, the issuer may find it profitable deliberately to default on its servicing obligation.

rangements); (c) float arising from the delay before payment to the certificate holder is due; and (d) the contract rate composition of the mortgages in the pool. Given the average servicing fee, the wider the range of contract rates, the less secure is the average fee because of the higher prepayment rate on high contract-rate mortgages.

3. Required Participation. An alternative approach is to require that the servicer retain an ownership interest in the pool. Then the failure to perform as servicer will hurt the servicer as a substantial investor in the pool.

The GNMA program requires that servicers retain a 44 basis point servicing fee, which assures that pool servicing will be profitable for many years, probably until maturity. Furthermore, GNMA has the right, in the event a servicer defaults on any one pool, to take over the servicing on all the GNMA pools of that servicer. It is thus not possible for a servicer to default selectively.

FNMA and the private market require a minimum servicing fee of 25 basis points.

On PCs, FHLMC requires that sellers of whole loans retain at least 37½ basis points; sellers of participations need not retain any servicing fee but if the fee is negative the lender must retain a participation interest large enough that the income on the participation covers the deficiency.[15] On PCs* FHLMC requires a 37½ point servicing fee or a zero servicing fee and minimum participation of 5%.

I. Insurance Premiums

The payment of insurance premiums is a transfer between the packager and the insurer, the investor being uninvolved.

On GNMAs the insurance premium is a flat 6 basis points. Since the servicing fee is always 44 basis points, the pool mortgage rate is always 50 basis points more than the certificate rate.

On FNMA passthroughs the insurance premium charged by FNMA is 25 or 35 basis points, depending on whether the lender or FNMA assumes the default risk. With a 25 basis point servicing fee, the lowest rate mortgage in an FNMA pool must be 50 or 60 basis points above the passthrough certificate rate while the highest rate mortgage that can be placed in the pool would be 250 points above that. For example, if the certificate rate is 7.50% the lowest and highest rate mortgages would be 8 or 8.1% and 10.5 or 10.6%, respectively.

On FHLMC's PC* program the insurance premium is set by auction or negotiation. If the seller retains at least a 5% participation the lowest rate mortgage that could be delivered would carry a rate equal to the certificate rate plus the accepted insurance premium. Thus, in the auction of November 2, 1981, the range of accepted bids on a 7% certificate was 7.35-7.65% or insurance premiums of 35 to 65 basis points. A winning bidder at 7.35% could thus deliver a 7.35% mortgage to FHLMC in exchange for a 7% passthrough (zero servicing fee), a 7.50% mortgage (15 basis point servicing fee), an 8% mortgage (65 basis point servicing fee), up to a maximum rate of 9.60% (225 basis point servicing fee). If no participation interest was retained, the lowest rate mortgage the bidder could deliver would be 7.725% and the maximum 9.725%.[16]

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[15] It is not clear that a participation requirement has any operational significance. A high servicing fee provides some assurance that in the event the servicer fails or defaults the investor can transfer the servicing to another agent without suffering loss. A participation interest would provide such protection only if the investor would have an enforceable legal claim to the income on the retained portion in the event of the servicing agent's bankruptcy.

On PCs there is no payment insurance—FHLMC insures itself—while on PTs and PTCs insurance premiums are negotiated with private mortgage insurance companies. While no published data are available, hazard and pool insurance are said to average about 12 basis points.

J. The Payment Function

Investors prefer to receive a single monthly payment and statement for all the passthroughs they own of a given type. This is an advantage of centralizing the issuance function, as under the FNMA and FHLMC programs. With GNMAs and PTs investors receive separate checks for every pool they own.

K. Size and Age of Individual Loans in Pools

In general, investors are indifferent to the size of individual loans in a pool if the passthrough carries sufficient insurance, and almost indifferent otherwise, although loans at the extremes of the size distribution are considered to be somewhat riskier than others. Investors are likely to be indifferent to the age of mortgages in the pool except to the degree that age is correlated with coupon rate or remaining life. Packagers prefer the widest latitude possible in pooling loans, as regards size, age, or any other characteristics.

Since the GNMA program is limited to mortgages insured or guaranteed by FHA, VA or FMHA, the maximum loan sizes for GNMA pools are the maximums under these insurance programs. FHLMC and FNMA are also subject to a statutory limit that changes every year; in 1982 it was $107,000. There is no hard and fast size limit on PTs and PTCs but Standard and Poors does not like to see loans that are far above the average in the market area, and in 1981 $250,000 appeared to be the self-imposed maximum.

Only GNMA requires that mortgages be new (less than one year old). FNMA will accept mortgages up to ten years of age while FHLMC and the private market impose no constraints, although until very recently FHLMC was limited in the proportion of mortgages they purchased that could be more than one year old. There are no age limits in the private market, although in practice most mortgages pooled are relatively new.

L. Summary Statement on Passthrough Characteristics

The various characteristics of existing passthroughs described above, which carry advantages and disadvantages for lenders and investors (as well as borrowers), fall into two broad categories. Some characteristics constitute policy-imposed constraints to prevent the benefits of programs carrying some element of Federal Government support from being disseminated too widely, or issuers from accepting excessive risk. Maximum loan sizes and mortgage insurance requirements on certificates guaranteed by GNMA, FHLMC and FNMA, and the one year age limit on GNMAs, fall into this category. The remaining characteristics are simply program design features that presumably aim at the best possible tradeoff between the interests of lenders, investors and insurers.

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[16] In early 1982 FHLMC stopped posting the certificate rate and sellers could thenceforth specify any certificate rate consistent with the accepted insurance premium and required servicing fee, rounded to 50 basis points. For example, if the accepted insurance premium was 40 basis points and the servicing fee 37½ points, the seller could specify a certificate rate of 7% and deliver mortgages carrying rates of 7.775% or more; or they could specify a certificate rate of 7½% and deliver mortgages carrying rates of 8.275% or more; and so on. If the seller wanted to liquidate, e.g., 8% mortgages, the highest certificate rate he could specify would be 8.000 − .775 = 7.225 rounded down to 7%.

It is not possible a priori to determine whether one passthrough design feature, or set of features, is better than another. Consider, for example, the following differences between the new PC* and FNMA* programs:

1. Where FHLMC auctions its commitments, collecting from 25 to 65 basis points, FNMA has set a fixed "participation fee" of 25 or 35 basis points, depending on whether the seller/servicer accepts the risk of foreclosure loss. FNMA is the only pass-through insuring agency which provides this type of option to seller/servicers.[17]
2. FNMA requires a minimum servicing fee of 25 basis points on every mortgage in a pool whereas FHLMC requires 37½ points or a 5% participation.
3. Minimum pool sizes are $1 million under FNMA and $5 million under FHLMC.
4. Payment on FNMAs* is due 25 days after the due date from borrowers, the same as on private passthroughs, whereas on PCs* the delay is 45 days.
5. Investors in FNMAs* are provided with a wider range of information regarding mortgage characteristics than investors in PCs*.

Ideally we would like the market to decide which set of design features is best, under a system of free and equal competition. An important question is whether such competition is possible in the long-run without prejudicing the capacity of the system to meet passthrough demands in the short run?

IV. MEETING THE MARKET'S NEED FOR CONVENTIONAL PASSTHROUGHS: THE CURRENT APPROACH

The demand for conventional passthroughs is likely to expand very rapidly over the next decade. This reflects not only the rising trend in housing demand but also a possible curtailment in the growth of the Federally insured and guaranteed sectors, as discussed in Section VII. In addition, thrift institutions which in the past financed conventional loan originations through deposit growth will grow much less rapidly in the future and will be forced increasingly to act as mortgage bankers. This trend is already well underway.

The new FHLMC and FNMA programs can be viewed as attempts by these agencies to fill this need. FHLMC believes that it requires additional capital to fill the expanding role it sees for itself, and in order to raise this capital it has proposed extensive changes in its structure and authority which are embodied in bill S1805.

> Currently, the corporation is owned solely by the twelve Federal Home Loan Banks that are holding $100 million in nonvoting stock. Its Board of Directors consists only of three members of the Federal Home Loan Bank Board. The Board has the authority to require the Federal Home Loan Bank System to guarantee the corporation's obligations (although this power has not been exercised).

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[17] The investor is, of course, insured against loss from default by FNMA regardless of whether the seller-servicer accepts default risk. Has FNMA considered the danger of adverse selection from offering this option?

> In addition, the corporation can use the Bank System, without statutory restrictions, to raise funds for its use . . .
>
> Under the bill, the corporation would no longer be able to borrow from the Federal Home Loan Bank System after 1982 except that the corporation would have a $200 million emergency backstop authority to the Federal Home Loan Bank System in the future as a last resort source of financing. The corporation would no longer be a member of the Federal Home Loan Bank System and the System could not guarantee FHLMC obligations.
>
> The corporation would gain the authority to issue various types of stock to its users and the public to raise the additional capital it needs . . .
>
> The Board of Directors of the corporation would be expanded from the current three members of the Bank Board to include six additional members elected by stockholders of the corporation.[18]

With some differences in detail, FHLMC with these changes would have a status very similar to that of FNMA, namely it would be a private corporation having public representatives on its board and an emergency credit line to a Federal agency.

A problem with this approach is that the Federal ties that FNMA and FHLMC retain give them a very marked advantage over other potential competitors in the market. The credit lines particularly are viewed as providing the agencies with access to Federal funds, and therefore as providing the Federal Government with an important stake in their solvency. The new status of FHLMC would not significantly change market perceptions on this score.

The advantage that Federal ties convey to FHLMC and FNMA is well illustrated by the great difficulty private conduits have experienced in competing with FHLMC's PC program. Thus:

1. The market will accept PCs at yields 20 to 40 basis points lower than those on PTCs. PCs are presumed to be less risky because of the Corporation's unqualified guarantee of payment of principal and interest, and because the Corporation is a quasi-government institution. PCs are also more liquid, reflecting the large amount outstanding, and their great homogeneity, which in turn is associated with FHLMC's guarantee.

2. Conduits and other private issuers have had to purchase pool and hazard insurance while FHLMC is self-insuring.

3. On public offerings, conduits are subject to SEC registration requirements and to state Blue Sky laws, while FHLMC is not. Conduits also find it necessary to obtain ratings from Standard and Poors.

4. Conduits are subject to constraints on the contract rates of mortgages placed in pools, while FHLMC is not. Conduits must report contract rate composition and much other information on pool characteristics while FHLMC reports nothing.

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[18] Mary Bruce Batte, "Opening Soon: FHLMC Recapitalization," *Mortgage Banking*, January 1982.

All the advantages of FHLMC listed above stem directly or indirectly from the Corporation's quasi-public status, and the perception of the market that the Federal government probably stands behind its insurance. If FHLMC were prepared to purchase any kind of conventional mortgage from any seller, and if its purchase capacity were unlimited (which it is not), there would be no private conduits. The private conduits operate only within the market space left them by FHLMC.

If we consider FHLMC not as a conduit but as a non-selling issuer as under its PC* program, or as an insurer only which is its ultimate objective, it still enjoys many advantages over strictly private competitors, as does FNMA. Private competitors would be left to play a marginal role at best in pooling mortgages that the agencies will not take, such as loans exceeding the maximum size limit, second mortgages, and the like.

If the central function performed by these agencies (basically the combination issuance-payment-insurance function) is a natural monopoly—that is, if it can be performed much more efficiently by one or two firms than by a number of firms—this may be the best market structure possible. The full implications of this for the Federal Government's contingent obligations should be recognized, however. As FHLMC and FNMA expand to guarantee a sizeable portion of the conventional mortgage stock, the possibility that the Federal Government could ever allow them to become insolvent becomes increasingly remote. While de jure the Government has no commitment to bail out FHLMC or FNMA in the event they get into serious trouble, de facto it would have little choice because the consequences of not doing so would be a financial disaster of mammoth proportions. In this sense, the privatization of FHLMC and FNMA, to the degree that it is viewed as a way of limiting the growth of the Federal Government's contingent liabilities, is largely illusory.

It is, furthermore, a costly illusion. If the Government would assume liability for FHLMC or FNMA to avert a disaster, it could earn sizeable revenues in insurance fees by making the guarantee explicit. Investors today require a premium on PCs, above the yield on explicit full faith and credit passthroughs (GNMAs), on the order of 35 basis points.[19] This amounts to $3.5 million per year foregone for each billion dollars of PCs outstanding, which is a heavy cost for pretending that the contingent liability does not exist.

V. IS THE CONVENTIONAL PASSTHROUGH MARKET A NATURAL MONOPOLY?

Federal Government support to one agency may create a monopoly, as with GNMA in pooling FHA and VA mortgages, or a "duopoly" in the case of FHLMC and FNMA in the conventional market, but these are natural monopolies only if there are powerful operating economies associated with having one or two firms.

In the passthrough issuance-guarantee function there are two types of economies of scale. One is operating economies in processing and administration, which evidently are not very pronounced. At least some private conduit firms, for example, believe that their costs are lower than those of FHLMC despite the substantially larger size of FHLMC.

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[19] While part of this may be a liquidity premium, differences in liquidity are ultimately due at least in part to the absence of full faith and credit insurance on PCs.

The second scale economy is associated with the efficiency of the market for the passthrough, particularly the secondary market. It was noted earlier that, other things the same, securities available in large volume enjoy a better market and are therefore more liquid; liquidity is a valued attribute of an asset for which investors are prepared to pay. Market efficiency increases over a wide range of volume, furthermore, although it does not increase indefinitely. Some feel for the magnitudes involved can be gleaned from the experience of the GNMA program. An efficient market existed in GNMAs in 1976 when the volume outstanding was $31 billion. The volume of conventional home mortgages outstanding today is about $800 billion. If 40% of that total or $320 billion were in passthroughs and $31 billion was needed for an efficient market, there could be efficient markets in 10 different varieties of conventional passthrough. This is a very rough and ready calculation—we would get different results if we used new issue data rather than outstandings, a different base date for GNMAs, or a different assumption regarding the proportion of the conventional market covered by passthroughs. Nevertheless, there is no plausible way to juggle the numbers where they imply that there is room for efficient markets in passthroughs of only two firms.

If the conventional passthrough issuance-guarantee function is not a natural monopoly there is reason to be concerned about a strategy that allows the market to be dominated by two firms that enjoy Federal support.

It might be argued that duopoly is not the same thing as monopoly, and at least the two firms will compete between themselves. Experience suggests, however, that competition between two giants is not a reliable way to assure good market performance because sooner or later they learn to be accomodative. In the case at hand, furthermore, both institutions have Federal ties of different types which can be perceived by the market as providing greater or less back up support to one or the other. Investor preferences, therefore, may be heavily influenced by perceptions of the strength of federal ties rather than by program design features.

VI. THE COMPETITIVE APPROACH

Unless elements of natural monopoly are involved, competitive market structures tend to be efficient in meeting society's needs over the long run. In the short run, however, the process of creating such a market where it does not already exist usually involves transition problems that must be [illegible].

To develop a competitive passthrough market, Federal ties to FHLMC and FNMA must be severed. This requires that there be no participation of Federal agencies in their governance and no emergency credit lines with Federal agencies. As noted earlier, credit lines from Federal Government agencies retain an umbilical tie and create an impression that Federal credit could be used if necessary to supplement the agency's capital in the event of losses—in short, to help ward off insolvency as well as to meet temporary cash shortages. Maintenance of this tie and the impression of capital support it creates provides FHLMC and FNMA with an unwarranted market advantage over other issuers. Severing Federal ties would largely if not entirely free the remainder of the private market from the burden of having to compete with agencies having

Federal Government support.

Perhaps the most challenging task in developing a competitive passthrough market would be to define an appropriate set of ground rules for all private players in the market. Many of the rules will be dictated by the market, and while markets tend to be more lenient with large firms (such as FHLMC and FNMA) it can be expected that differences in treatment will be reasonable and liveable for the smaller firms. In two areas, however, Government is involved in rule setting and these deserve special consideration.

A major problem is SEC registration, which is now required on public offerings of private issuers but not on any offerings of FNMA or FHLMC. Presumably the premise underlying their being exempt from registration requirements is that since there is Federal involvement in their governance, SEC-type safeguards are not needed to protect the public interest. And it would be plausible to infer that Federal involvement being removed, FHLMC and FNMA should be required to register.

On the other hand SEC registration would seriously burden FHLMC's new PC* and both of FNMA's programs because it would require that every lender swapping mortgages for passthroughs under these programs would be obliged to register them prior to selling them to investors. Their liquidity would be effectively destroyed. But if these programs are exempted, why should not other firms wishing to develop similar swap programs also be exempted? Yet serious abuse could arise from a blanket exemption of any mortgage passthrough.

One approach to this problem might be to authorize the Federal Home Loan Bank Board to establish guidelines for the exemption of passthroughs from SEC registration requirements, and to establish a simple administrative procedure for making determinations in individual cases where this is necessary.

Severing the Federal ties of FNMA and FHLMC involves several potential problems to which consideration must be given. The agencies are now viewed as having social objectives as defined by the Congress. Mortgage purchase programs supported by debt issues, the parameters of which are set by Congress, embody such objectives. While passthrough operations per se require minimal credit lines which FNMA and FHLMC could easily obtain in the private market, debt-supported mortgage portfolios may require Federal standby credit lines to meet debt rollover contingencies. Indeed, it could be argued that capital losses on debt-supported portfolios make the credit lines necessary to support the agencies solvency. This is less a problem with FHLMC whose debt-supported portfolio is only a fraction of FNMA's. As part of its proposed recapitalization package, FHLMC's existing blank check with the FHLB System would be converted into a $200 million emergency line, and probably the corporation could function without any line at all. FNMA on the other hand might be viewed by the market as insolvent without its credit line while with the line the agency's credit status in the market is stronger than that of any private issuer. It is not clear that there is any way to eliminate this advantage of FNMA's short of forcing them to cease operations in the passthrough market.

A legitimate question also can be raised whether, if FHLMC was completely privatized in the sense indicated above and FNMA ceased passthrough operations, the remainder of the private market could generate sufficient volume to fill the need? While I don't know the answer to this question, it seems evident that if the private market would *not* take up the slack, it would be because of a perceived need by the investment community for Federal Government backing.

VII. PRIVATIZATION AND THE GNMA PROGRAM

The further development of the conventional passthrough market might be stimulated if constraints were imposed on the GNMA program. A number of other considerations are involved in such a policy determination, however, including the allocation effects of curbing the GNMA program, the benefits to capital market efficiency of that program, and whether those benefits could be retained by a scaled-down program, or through a different approach.

A. Resource Allocation

The GNMA program on balance increases the allocation of resources to the residential sector, even though a major portion of GNMA-supported credit replaces other residential credit. Whether such reallocation is appropriate is now a controversial issue.

Until recent years this issue would not have arisen because the view that the Federal Government should encourage a shift of resources into residential construction, particularly for the benefit of low and middle-income home buyers, was firmly embedded in public policy. Today this view is under challenge by its opposite, namely, that the overall result of Federal Government policies (including tax policies) has been to shift an *excessive* volume of resources into this sector. While the Economic Recovery Tax Act of 1981 has significantly reduced the tax advantage of housing relative to other investments, the resource allocation issue remains an open one.

B. Capital Market Benefits

As noted earlier, sufficient insurance on passthroughs reduces fixed pool costs and increases marketability, which in turn provides direct market access to small loan originators. Furthermore, a passthrough with sufficient insurance provides a pricing benchmark for all other passthroughs and in this way improves the efficiency of the entire residential mortgage market. In addition, if available in significant volume, a passthrough with sufficient insurance makes possible an organized future's market, which allows mortgage originators and investors, as well as financial institutions who do not ordinarily invest in mortgages or passthroughs, to hedge against interest rate risk. In a world of marked interest rate instability, this is of considerable importance, and involves a spill-over of benefits to the entire capital market.

On the other hand, there is no way of determining whether the particular program structure established by GNMA is an efficient one. Since the GNMA program is the only full faith and credit program in the marketplace and since this is a feature many investors find important, the program's structure is not subject to the test of competition.

C. Reducing the Scale of the Program

If on balance there are reservations concerning the allocative effects of the GNMA program, either in terms of the impact on the residential sector generally or on the specific beneficiaries of the program, it becomes relevant to ask whether the scale of the program could be cut without seriously undermining its beneficial effects on capital market efficiency. Would the program be about as effective if the volume of new GNMA issues was only $5-10 billion per year instead of $15-25 billion?

While the extensive existing network of GNMA dealers suggests that some curtailment is possible without impairing market efficiency, how great this might be cannot be determined without a detailed study, and perhaps not even then. It is not clear, for example, whether or not the market could survive a major cutback such as the removal of the FHA Section 203 program from eligibility.

D. Is Double Full Faith and Credit Insurance Coverage Necessary?

If the major concern with the GNMA program is less the resource allocation effects than the growth of Federal Government commitments, it is relevant to ask whether GNMAs really require the double level of Federal commitment they now have. Given that the underlying mortgages carry full faith and credit insurance, must the payment guarantee be full faith and credit also?

One might think not because the major risk in any pool is loss of principal from borrower default and except for some minor costs this is covered by the mortgage insurance. The remaining risks are very small. They consist of losses from servicer default when servicing becomes unprofitable, or fraud. Servicer defaults have been very few because of the high required servicing fee and because in the event of default on a single pool GNMA can take over all the pools of the defaulting servicer. Losses from fraud are predictable from experience and controllable. Since the program's inception in 1970 losses from all sources have been very small.

Whether a passthrough against Federally insured mortgages carrying a payment guarantee from a well-capitalized private firm would be viewed by the market as the equivalent of GNMAs is not clear. While no such passthrough emerged prior to the GNMA program, perhaps GNMAs extremely favourable experience might provide the basis for such a venture. Perhaps not. Unfortunately, there is no way this type of passthrough could succeed unless GNMA ceased operations and then it might take many years before it could be determined whether the experiment was a success.

VIII. SUMMARY

The existing approach to the conventional passthrough market appears to be to allow FNMA and FHLMC to meet the market demand while retaining their ties to the Federal Government. This approach provides the greatest assurance that the market's needs will be met, and that the efficiency of the two agencies will not be deadened by bureaucratic controls. However, the remainder of the private market will never play more than a marginal role under this approach, while the Federal Government will assume what could be an enormous contingent obligation without any compensation.

The strict private enterprise approach involves severing all of FHLMC's and FNMA's links with the Federal Government, looking to the rest of the private market to fill the void. Severing ties means that there be no further participation of Federal agencies in the governance of FNMA and FHLMC, and no provision of emergency credit lines. The second requirement would be difficult for FNMA to meet because of its weak financial condition. All private issuers and guarantors would be subject to a single set of groundrules, including exemption from SEC registration requirements under stipulated conditions.

The GNMA program confers significant benefits to the residential mortgage market and to the capital markets generally. If the allocational effects of the program are viewed as undesirable, a case can be made that the program could be reduced in size without significantly affecting capital market efficiency, although the extent of the possible reduction would require further study. It is possible, given that the mortgages in GNMA pools carry full faith and credit mortgage insurance, that the market would accept payment insurance by a well-capitalized private firm as virtually the equivalent of GNMAs.

APPENDIX: FHLMC AND THE PROVISION OF INFORMATION ON POOL CHARACTERISTICS

FHLMC, as a matter of policy, makes public very little information on the characteristics of mortgages in the pools underlying participation certificates (PCs). The basic rationale is that by disclosing such information to the market, PCs are more homogeneous than they would be otherwise, and therefore their overall marketability and attractiveness to investors is enhanced. This view is examined here.

In its offering circular for PCs, FHLMC provides some very general information on the characteristics of mortgages that they place in PC pools, but the only specific information available with regard to individual pools is the average contract rate, which is published once a year, and the balance outstanding, which is made available every month. (Disclosure of monthly balance data is necessary for trading purposes.) Since the exact composition of contract rates within the pool is not known, changes in the balance from scheduled amortization and from prepayments in full cannot be precisely separated, although the separation can be estimated. If the contract rate composition of the mortgages in the pool were available every month, pool prepayment patterns could be defined more precisely, and predicted with smaller error. Other data on mortgage characteristics which bear on prepayment rates, such as original loan to value ratios or location of property, would reduce the error even more. This would permit finer distinctions between the cash flow characteristics of the separate pools. The question at issue is whether or not it is to FHLMC's advantage to permit this.

Let the attractiveness to investors of a passthrough issued against a pool of mortgages be represented by the yield at which they are prepared to accept it, denoted Y_P for pool P, $Y_{P'}$ for pool P′, and so on. The more attractive the instrument, the lower the yield. Passthroughs have many characteristics that bear on their appeal to investors, but only two need to be considered in this analysis: the variance in expected cash flows (V), and marketability (M). In general, investors will demand a higher yield when cash flow variance is high, and will accept a lower yield when marketability is high. (The relationship of required yield to the expected pattern of cash flows is indeterminant and need not concern us in this paper.)

If V_p and $V_{p'}$ are reduced by the provision of more information bearing on cash flows Y_p and $Y_{p'}$ will decline unless this is offset by a reduction in marketability. FHLMC's case for nondisclosure rests on the assumption that this is indeed what would happen. Let's examine this.

The marketability M_p of a passthrough P is affected by a number of factors, but the only factors we need consider are the outstanding volume of the instrument A_p, the volume of close substitutes ($A_{p'}$), and the extent of substitutability between P and P'. As substitutability rises, $A_{p'}$ becomes more important in affecting M_p, and at the limit, when substitutability is perfect, $A_{p'}$ has the same effect on M_p as A_p.

How would these factors affect M_p and $M_{p'}$ when more information is provided on expected cash flows? It is clear that neither A_p nor $A_{p'}$ is affected, but the degree of substitutability between P and P' may be. Better estimates of expected cash flows may increase or reduce the perceived differences in cash flow patterns between different pools, and therefore may increase or reduce the substitutability of any pair of pools. We would expect any given pool to become a better substitute for some pools and a poorer substitute for others. Over the entire 128 PC pools, there should be little net change in substitutability, and therefore marketability overall should not be affected. If marketability is not affected, the reduced variance in cash flow patterns should reduce the yield required by investors.

There is one possible objection to this analysis. It could be argued that investors unaware of cash flow differences between different pools might become aware of the differences if more information was provided. At present, these investors view P and P' as interchangeable, but if the differences were sharpened they might come to view them as separate instruments, which would reduce marketability.

There do seem to be investors who ignore the cash flow characteristics of mortgages and mortgage related securities and buy solely on the basis of expected yield. But the argument that such investors, who don't use all the available data now, would change their pattern if more data were provided, is not very plausible. Besides, the unsophisticated investors will slowly dwindle in importance.

For the Hearing Record
May 5, 1983

Testimony of Professor Kenneth T. Rosen
Professor of Economic Analysis and Policy
Graduate School of Business
Chairman, Center for Real Estate and Urban Economics
University of California at Berkeley

before

Senate Subcommittee on Housing and Urban Affairs
April 28, 1983

In the past three years the U. S. economy has experienced the worst economic conditions since the 1930s. This is reflected in stagnant economic growth, the highest unemployment rates since the Great Depression, and a decline in the value of most real assets, including houses. Despite the beginnings of economic recovery, this near-depression is continuing in many regions, for many industries, and for many individuals. As a result of these adverse economic conditions, a large number of individuals are delinquent on their mortgage loan payments or are in the process of losing their homes through foreclosure. As a result of the economic catastrophe of the past three years, they have lost their jobs, medical insurance, and have lost or on the verge of losing that last tie to a stable and responsible role in American society, their home. In my view, Congress has a strong equity obligation to assist those Americans, who because of the loss of employment are on the verge of the foreclosure and loss of their homes. As a result, I would strongly support a version of the "Umemployed Homeowners' Relief Act of 1983" as embodied in S.846 and S.466 or the Heinz-Riegle Amendment on Mortgage Default Assistance.

The remainder of my testimony will document the extent and causes of the mortgage delinquency and foreclosure problem. I will also address ways to optimally define such a program.

Extent of the Mortgage Delinquency and Foreclosure Problem

The percentage of mortgage delinquencies (pa[illegible] 90 days past due) and home mortgage foreclosures is [illegible] the highest level in recent years. Table I shows that the new foreclosure and mortgage delinquency rate on conventional loans is up 50% when compared with the previous severe housing recession in 1975. In comparison with the last good housing year of 1979, mortgage delinquency and foreclosure rates on conventional loans are up more than 100%.

It has been stated by some in this administration that the foreclosure rate was actually higher in the housing recession of 1974-75. This is in fact only true if one includes the government subsidized sector of the market and the foreclosures that followed the scandals relating to Section 235 and Section 236. Excluding this scandal ridden data, there is no doubt that the mortgage delinquency and foreclosure problem is extremely serious and much worse than during previous periods. It is estimated that nearly 150,000 Americans are in the process of losing their homes

Table 1
NATIONAL DELINQUENCY AND FORECLOSURE RATES
QUARTERLY

---------CONVENTIONAL LOANS----------					FHLBB
Total Past Due (6)	30 Days Past Due (7)	60 Days Past Due (8)	90+ Days Past Due (9)	New Fcls (10)	Delinquent Loan Ratio (11)
2.64	1.89	0.44	0.31	0.09	1.38
2.69	1.94	0.45	0.30	0.10	1.43
2.75	1.94	0.48	0.33	0.09	1.50
2.79	1.96	0.47	0.36	0.09	1.52
2.72	1.93	0.45	0.34	0.07	1.59
2.86	2.00	0.48	0.38	0.08	1.45
2.87	2.05	0.47	0.35	0.08	1.37
2.81	1.99	0.48	0.34	0.09	1.31
2.68	1.91	0.46	0.31	0.09	1.31
2.80	2.00	0.48	0.32	0.08	1.16
2.76	1.98	0.47	0.31	0.07	1.11
2.76	2.00	0.46	0.30	0.07	1.06
2.75	1.99	0.47	0.29	0.07	1.06
2.65	1.95	0.42	0.28	0.06	0.96
2.68	1.98	0.42	0.28	0.06	0.93
2.66	2.00	0.40	0.26	0.07	0.90
2.66	2.01	0.41	0.24	0.07	0.93
2.56	1.95	0.36	0.25	0.06	0.87
3.03	2.36	0.43	0.24	0.06	0.85
2.82	2.12	0.44	0.26	0.06	0.87
3.04	2.30	0.47	0.27	0.07	0.94
3.09	2.30	0.51	0.28	0.07	0.98
3.06	2.25	0.51	0.30	0.08	1.08
3.14	2.28	0.53	0.33	0.09	1.13
3.07	2.27	0.48	0.32	0.09	1.24
3.24	2.35	0.55	0.34	0.11	1.19
3.43	2.50	0.58	0.35	0.11	1.30
3.31	2.39	0.57	0.35	0.11	1.43
3.52	2.52	0.58	0.42	0.13	1.66
3.68	2.55	0.65	0.48	0.13	1.75
3.79	2.61	0.66	0.52	0.14	1.95
3.81	2.63	0.65	0.53	0.14	2.20

FOOTNOTES

(1-10) Seasonally adjusted rates in percent
Source: Mortgage Bankers Assoc., National Delinquency Survey

(11) Percent - Dollar amount of mortgage loans and contracts delinqent 60 days or more as a percent of total mortages and contracts held at end of month.
Source: FHLBB News, Savings & Loan Assoc. Activity

Source: RDA/Chase Econometrics

through foreclosure. Over 1.5 million American families are delinquent in their mortgage payments.

Even these national aggregate figures understate the true magnitude of the problem for those geographic regions that have been most adversely effected by the recession. As Table II and III and Figure I show, some states have a far more serious crisis. Table II shows the delinquency and foreclosure rates in the fourth quarter of 1982, while Table III shows the same rates for the fourth quarter of 1979, for all states. The states of California, Florida, Ohio, and Nevada have shown especially large increases in problem loans. In addition, states such as Michigan have shown a 200% increase, Pennsylvania a 100% increase, and Washington over a 200% percent increase in delinquent loans. Even a state like Texas has seen a 60% increase in loan delinquencies. On the other hand, states such as New York and New Jersey have experienced much smaller increases in problem loans.

TABLE II

MORTGAGE DELINQUENCY AND FORECLOSURE RATES

1982 : 4

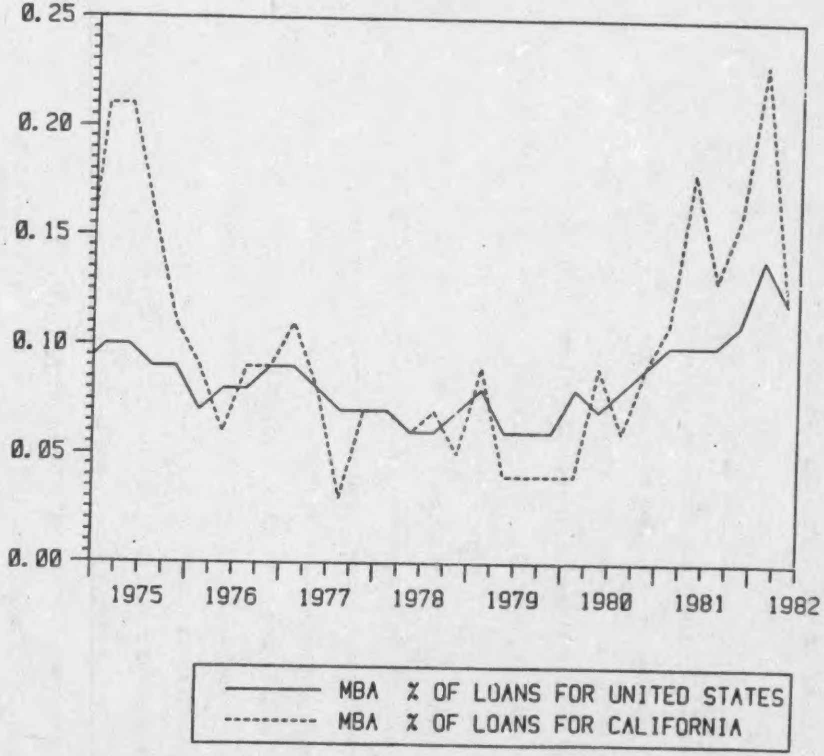
STATE	90 DAYS OR MORE PAST DUE	FORECLOSURES STARTED DUR QTR.	FORECLOSURES AT END OF QTR.
ALABAMA	0.37	0.27	0.29
ALASKA	0.18	0.10	0.43
ARIZONA	0.44	0.20	0.51
ARKANSAS	0.37	0.17	0.34
CALIFORNIA	0.62	0.13	0.83
COLORADO	0.51	0.09	0.23
CONNECTICUT	0.74	0.05	0.17
DELAWARE	0.20	0.04	0.12
DIST OF COLUMBIA	0.67	0.24	0.73
FLORIDA	0.79	0.12	0.43
GEORGIA	0.40	0.18	0.25
HAWAII	0.98	0.15	0.39
IDAHO	0.77	0.32	0.58
ILLINOIS	0.48	0.12	0.40
INDIANA	0.39	0.13	0.39
IOWA	0.63	0.05	0.08
KANSAS	0.98	0.18	0.45
KENTUCKY	0.46	0.16	0.55
LOUISIANA	0.27	0.04	0.18
MAINE	0.61	0.12	0.42
MARYLAND	0.25	0.06	0.19
MASSACHUSETTS	0.18	0.12	0.16
MICHIGAN	0.54	0.18	0.35
MINNESOTA	0.50	0.12	0.29
MISSISSIPPI	0.48	0.13	0.07
MISSOURI	0.31	0.14	0.22
MONTANA	0.28	0.06	0.17
NEBRASKA	0.57	0.23	0.58
NEVADA	0.61	0.69	1.33
NEW HAMPSHIRE	0.30	0.13	0.08
NEW JERSEY	0.37	0.07	0.33
NEW MEXICO	0.36	0.12	0.37
NEW YORK	0.60	0.07	0.21
NORTH CAROLINA	0.22	0.06	0.12
NORTH DAKOTA	0.25	0.00	0.50
OHIO	1.22	0.10	0.83
OKLAHOMA	0.43	0.09	0.20
OREGON	0.64	0.52	0.68
PENNSYLVANIA	0.62	0.12	0.28
RHODE ISLAND	0.38	0.15	0.53
SOUTH CAROLINA	0.23	0.13	0.28
SOUTH DAKOTA	0.73	0.00	0.73
TENNESSEE	0.51	0.11	0.12
TEXAS	0.38	0.10	0.08
UTAH	0.88	0.30	0.94
VERMONT	1.51	0.25	1.17
VIRGINIA	0.32	0.04	0.12
WASHINGTON	0.39	0.17	0.35
WEST VIRGINIA	0.48	0.13	0.10
WISCONSIN	0.70	0.10	0.33
WYOMING	0.93	0.25	0.63

TABLE III
MORTGAGE DELINQUENCY AND FORECLOSURE RATES
1979 : 4

STATE	90 DAYS OR MORE PAST DUE	FORECLOSURES STARTED DUR QTR.	FORECLOSURES AT END OF QTR.
ALABAMA	0.28	0.04	0.10
ALASKA	0.56	0.10	0.16
ARIZONA	0.11	0.03	0.07
ARKANSAS	0.23	0.00	0.14
CALIFORNIA	0.16	0.04	0.06
COLORADO	0.11	0.05	0.05
CONNECTICUT	0.41	0.04	0.08
DELAWARE	0.21	0.11	0.04
DIST OF COLUMBIA	0.87	0.19	0.50
FLORIDA	0.29	0.04	0.10
GEORGIA	0.46	0.10	0.22
HAWAII	0.42	0.01	0.05
IDAHO	0.46	0.08	0.13
ILLINOIS	0.35	0.06	0.20
INDIANA	0.16	0.04	0.08
IOWA	0.24	0.03	0.06
KANSAS	0.18	0.00	0.00
KENTUCKY	0.08	0.08	0.16
LOUISIANA	0.07	0.09	0.07
MAINE	0.40	0.03	0.09
MARYLAND	0.22	0.07	0.11
MASSACHUSETTS	0.25	0.06	0.07
MICHIGAN	0.18	0.08	0.06
MINNESOTA	0.19	0.04	0.05
MISSISSIPPI	0.17	0.12	0.05
MISSOURI	0.10	0.03	0.03
MONTANA	0.33	0.11	0.11
NEBRASKA	0.61	0.00	0.09
NEVADA	0.13	0.02	0.04
NEW HAMPSHIRE	0.07	0.07	0.07
NEW JERSEY	0.37	0.07	0.20
NEW MEXICO	0.52	0.03	0.11
NEW YORK	0.45	0.08	0.20
NORTH CAROLINA	0.17	0.06	0.07
NORTH DAKOTA	0.00	0.00	0.00
OHIO	0.15	0.06	0.17
OKLAHOMA	0.43	0.10	0.15
OREGON	0.20	0.04	0.04
PENNSYLVANIA	0.33	0.06	0.12
RHODE ISLAND	0.19	0.19	0.06
SOUTH CAROLINA	0.25	0.16	0.17
SOUTH DAKOTA	0.00	0.00	0.00
TENNESSEE	0.25	0.06	0.06
TEXAS	0.23	0.03	0.02
UTAH	0.51	0.07	0.10
VERMONT	0.00	0.00	0.00
VIRGINIA	0.23	0.04	0.06
WASHINGTON	0.16	0.03	0.03
WEST VIRGINIA	0.25	0.00	0.03
WISCONSIN	0.55	0.07	0.13
WYOMING	0.34	0.11	0.06

FIGURE I

FORECLOSURES STARTED
UNITED STATES AND CALIFORNIA



Causes of Mortgage Delinquency and Foreclosure Problem

The increase in the mortgage delinquency and foreclosure problem in the past three years can be attributed overwhelmingly to the rise in unemployment. While there is normally some level of delinquency and foreclosure due to bad credit risks, illness, and divorce, these "normal levels" are probably closely approximated by the statistics in Table III. Using a statistical technique known as regression analysis, over 80% of the increase in problem loans can be attributed to the record post-war high in unemployment rates. Table IV shows the unemployment rate data by states that were used in our regression equations.

While the rise in unemployment is by far the most important factor in the rise in problem loans, several other factors must be considered. The expanded use of "creative financing" involving the provision of multiple junior mortgages has probably caused some households to overextend themselves and so default on their mortgage loans. In addition, the decline in real home prices in the

Table IV
UNEMPLOYMENT RATES BY STATE AND DIVISIONS
1982 TO 1983

	1982	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	JAN
U.S.	9.7%	9.6%	9.5%	9.2%	9.1%	9.8%	9.8%	9.6%	9.7%	9.9%	10.4%	10.5%	11.4%
NEW ENGLAND	7.8	8.3	7.8	8.0	8.0	8.3	8.9	7.4	7.1	7.2	6.9	7.4	8.9
CONNECTICUT	7.0	7.6	7.1	6.9	6.5	6.9	7.1	6.6	6.5	6.9	6.9	7.0	8.3
MAINE	8.4	8.9	9.3	9.3	9.3	8.9	9.7	7.6	7.5	6.8	7.0	8.3	10.0
MASSACHUSETTS	7.9	8.3	7.6	8.0	8.6	9.0	9.6	7.6	7.4	7.2	6.5	7.1	8.7
NEW HAMPSHIRE	7.4	7.7	7.5	8.1	7.3	7.3	9.1	6.5	6.3	7.1	7.0	7.7	8.5
RHODE ISLAND	9.7	10.2	10.3	9.9	9.2	9.3	10.4	9.5	8.6	9.1	9.5	10.0	12.2
VERMONT	7.3	8.7	8.6	9.0	7.6	7.2	6.9	6.3	5.7	6.0	6.7	7.2	8.0
MIDDLE ATLANTIC	9.4	9.7	9.4	8.8	8.9	9.1	9.2	9.1	9.2	9.6	10.2	9.9	11.2
NEW JERSEY	9.0	9.3	9.2	8.9	9.7	8.6	8.4	8.7	8.6	8.3	9.4	8.8	9.0
NEW YORK	8.6	9.0	8.6	7.8	7.9	8.5	8.5	8.4	8.4	9.0	9.5	8.6	9.6
PENNSYLVANIA	10.9	11.0	10.6	10.3	9.8	10.3	10.7	10.3	10.9	11.2	11.6	12.5	14.9
EAST NORTH CENTRAL	12.5	12.3	12.5	12.0	11.5	12.2	12.4	12.2	12.3	12.8	13.7	13.9	14.6
ILLINOIS	11.3	10.1	10.2	10.1	10.6	11.7	12.2	11.4	12.1	12.0	12.7	12.6	13.5
INDIANA	12.2	13.3	12.9	12.3	11.3	11.5	11.4	11.1	11.4	12.0	13.0	12.8	13.8
MICHIGAN	15.5	16.1	17.0	15.5	14.3	14.3	14.7	14.5	14.5	14.9	16.4	17.3	17.0
OHIO	12.5	12.2	12.3	12.0	11.1	12.3	12.2	12.5	12.3	13.2	14.0	14.1	14.9
WISCONSIN	10.4	9.7	10.0	10.2	9.7	10.2	10.3	10.4	10.3	10.7	11.1	11.9	13.4
WEST NORTH CENTRAL	7.7	8.3	8.0	7.2	6.8	7.5	7.5	7.5	7.4	7.5	8.2	8.4	9.8
IOWA	9.0	10.3	10.3	8.8	7.9	8.7	8.7	8.3	7.7	7.9	8.5	9.3	10.9
KANSAS	6.3	5.7	5.5	5.4	5.5	6.2	6.4	7.1	7.1	7.0	7.1	7.0	7.6
MINNESOTA	7.6	7.7	7.7	7.0	6.7	7.3	7.3	7.3	7.2	7.6	8.6	8.7	10.4
MISSOURI	9.1	10.2	9.2	8.5	7.9	8.7	9.0	9.0	8.9	8.7	9.5	9.4	10.9
NEBRASKA	5.9	6.2	6.3	5.2	5.4	5.8	5.8	5.5	5.4	5.6	6.2	6.7	7.9
NORTH DAKOTA	5.5	5.7	5.3	5.0	4.3	4.7	4.6	4.7	4.8	5.5	6.9	6.5	9.4
SOUTH DAKOTA	5.3	5.8	5.6	5.1	4.5	5.3	4.5	4.3	4.6	5.0	5.8	6.0	7.7
SOUTH ATLANTIC	8.8	8.8	9.0	8.2	8.2	8.7	8.8	8.6	8.6	9.1	9.3	9.2	10.1
DELAWARE	8.7	10.1	8.2	7.6	7.2	9.0	8.3	10.0	7.9	7.7	9.2	7.5	8.4
DIST OF COLUMBIA	10.7	10.1	10.6	10.6	10.6	11.4	11.8	11.0	11.0	11.1	10.9	10.8	10.3
FLORIDA	8.2	7.1	8.6	7.9	7.3	7.7	7.5	7.8	8.2	9.2	9.5	9.5	10.4
GEORGIA	7.8	8.1	7.7	7.2	7.4	8.1	8.1	7.5	7.6	7.8	8.1	7.8	8.2
MARYLAND	8.7	9.7	9.3	8.7	8.6	9.0	8.7	8.6	8.1	8.0	7.7	8.4	9.1
NORTH CAROLINA	9.1	9.3	9.7	8.2	8.7	9.2	9.8	9.0	8.7	9.3	9.5	8.9	10.0
SOUTH CAROLINA	11.1	11.3	10.9	10.5	11.4	11.5	11.7	11.3	10.7	10.8	10.8	10.9	11.6
VIRGINIA	7.7	8.1	7.9	7.2	7.1	7.4	7.6	7.2	7.4	7.8	8.1	8.1	9.0
WEST VIRGINIA	13.5	12.4	11.3	11.2	10.9	12.3	13.7	13.6	14.0	15.3	16.4	17.0	20.4
EAST SOUTH CENTRAL	12.1	12.2	11.8	11.0	11.0	11.9	12.5	12.1	12.0	12.3	12.5	13.0	13.9
ALABAMA	14.4	14.0	14.1	13.1	13.4	14.0	14.7	14.3	14.5	15.1	15.4	15.5	16.6
KENTUCKY	10.9	11.5	10.7	10.3	9.8	10.7	11.3	10.9	10.7	10.8	10.8	11.7	12.4
MISSSISSIPPI	11.2	10.2	9.6	9.6	10.0	11.6	12.3	12.6	12.2	12.3	11.9	11.8	12.2
TENNESSEE	11.6	12.3	12.0	10.7	10.6	11.2	11.7	11.1	10.9	11.2	11.9	12.7	13.7
WEST SOUTH CENTRAL	12.1	6.8	6.7	6.8	7.1	8.3	8.0	7.8	8.4	8.2	8.3	8.3	9.1
ARKANSAS	14.4	11.6	10.7	9.6	9.2	9.6	9.5	9.8	9.5	9.7	10.1	10.8	11.1
LOUISIANA	10.9	9.8	10.1	10.2	10.5	11.8	11.4	11.2	11.1	11.2	11.0	11.6	11.3
OKLAHOMA	11.2	4.9	4.8	5.0	5.3	5.7	6.1	5.7	6.0	6.5	6.7	6.8	7.7
TEXAS	11.6	5.8	5.7	5.9	6.3	7.7	7.3	7.0	8.0	7.6	7.6	7.4	8.5
MOUNTAIN	7.7	8.1	8.0	7.8	8.1	8.6	8.8	8.8	8.7	9.2	9.4	9.6	10.6
ARIZONA	10.2	7.9	8.3	8.3	9.2	10.4	11.0	11.2	10.7	10.6	10.3	10.5	11.1
COLORADO	10.8	6.8	6.7	6.7	6.9	7.2	7.3	7.2	7.6	8.3	8.9	8.6	9.5
IDAHO	5.7	12.0	10.8	10.5	9.9	9.2	9.0	8.9	7.7	8.0	8.6	9.8	12.9
MONTANA	6.9	10.7	10.4	9.2	8.5	9.1	8.5	7.7	7.5	8.3	9.5	9.8	10.9
NEVADA	8.6	8.4	8.3	8.6	8.7	9.3	9.9	10.2	10.4	11.0	11.3	11.5	12.3
NEW MEXICO	9.7	7.5	7.7	7.8	9.1	10.1	10.0	10.0	9.9	10.4	9.9	9.8	10.6
UTAH	7.4	9.2	8.2	7.6	7.0	7.4	7.5	7.5	7.7	8.1	8.8	8.7	9.7
WYOMING	9.7	4.8	4.9	5.1	4.9	5.3	5.6	5.7	5.4	6.4	6.8	7.9	9.9
PACIFIC	9.0	10.2	10.2	9.9	9.5	9.8	10.7	10.3	9.8	10.4	11.1	11.2	11.9
ALASKA	9.7	11.4	11.2	10.7	10.1	10.0	8.8	8.3	7.8	8.6	9.8	10.6	12.3
CALIFORNIA	9.2	9.6	9.7	9.4	9.0	9.4	10.7	10.2	9.7	10.3	11.0	11.0	11.7
HAWAII	8.0	5.5	5.8	6.0	6.4	7.7	7.6	7.6	7.9	7.8	7.0	6.6	5.6
OREGON	5.7	12.5	12.3	11.8	11.1	10.9	10.4	10.3	10.0	10.4	11.9	11.8	13.6
WASHINGTON	10.2	12.9	12.5	12.5	12.1	12.2	12.2	11.9	11.1	11.4	12.4	13.0	[illegible]

FOOTNOTES
Not seasonally adjusted

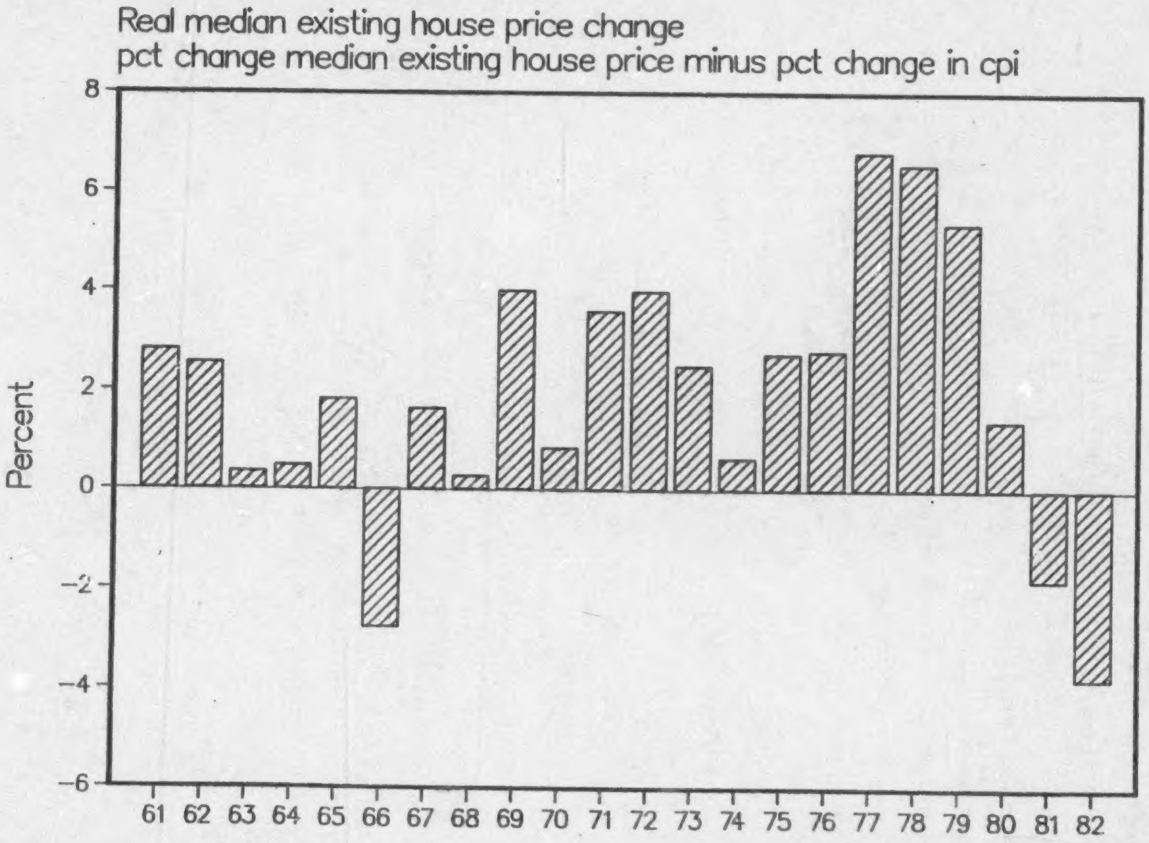
Source: RDA/Chase Econometrics

past several years (see Figure II) has probably contributed to defaults by households who have little equity in their homes. However, we must emphasize that the vast majority of the increase in problem loans is due to the cyclical rise in unemployment. As a result, even if the economy follows the optimistic forecast of the Administration, the unemployment rate will still remain over 9% by year-end and the mortgage foreclosure problem will remain serious well into any moderate economic recovery.

Methods to Mitigate the Delinquency and Foreclosure Problem

The proposals before the Congress, if passed, would represent a major step in mitigating the catastrophic impact of unemployment on those unfortunate Americans who have lost their jobs and exhausted their unemployment benefits. The rational behind such temporary assistance, in the form of a second mortgage loan guarantee, is that those Americans in such situations are victims of macroeconomic circumstances

Figure 2


Real median existing house price change
pct change median existing house price minus pct change in cpi
Percent
8
6
4
2
0
−2
−4
−6
61
62
63
64
65
66
67
68
69
70
71
72
73
74
75
76
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82

beyond their control. This program must be specifically targeted to exclude use by those who have loan problems because they are bad credit risks or because they were housing speculators. It also must be targeted to exclude the hard core unemployed and the "search unemployed". If the program was perceived as an entitlement rather than as temporary targeted assistance it could actually be counter productive and increase unemployment. It must be viewed as a last resort by both lenders and borrowers.

The following criteria might be useful in defining such a targeted program. The loan guarantee would only be available for the following:

(1) family households in which the primary earner is unemployed and has exhausted his/her unemployment benefits within the past year and in which other household member holds a full time job;

(2) the mortgage is on the principal residence of an owner-occupied residence;

(3) the household has at least three years of good payment history prior to unemployment;

(4) the household has exhausted all assets other than $2000, his/her car and house; and

(5) foreclosure would occur without this loan guarantee.

While these and other provisions would target this program, the biggest single difficulty of a program like this is to assure that the recipients have no other reasonable alternative in the private sector. Unfortunately, because of the myraid of problem loans, the extent to which private sector forebearance can alleviate this problem, even when the long run economic situation of the individual and the property justify it, is limited. Thus government intervention on a targeted basis is warranted.

Summary

The increase in the mortgage delinquency and foreclosure problem is primarily due to the near-depression of the past three years. Even a moderate economic recovery is unlikely to reduce unemployment in a way that will significiantly alleviate the foreclosure problem. Temporary mortgage payment assistance targeted towards the cyclically unemployed who have exhausted their unemployment benefits makes sense from an economic and social viewpoint. In the end, our government will be judged by how well we deal with those less fortunate elements in society who experience catastrophic loss. I thus urge you to support a version of the pending legislation.

Statement of
The Associated General Contractors of America
Submitted to the
Committee on Banking, Housing & Urban Affairs
Subcommittee on Housing & Urban Affairs
United States Senate
May 16, 1983
On The Topic Of
Amendments to the Housing & Community Development
Act of 1983, S644 -- Amendments to the Federal National
Mortgage Association Charter Act

AGC is:

* More than 32,000 firms including 8,500 of America's leading general contracting firms responsible for the employment of 3,5000,000-plus employees;
* 112 chapters nationwide;
* More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities;
* Approximately 50% of the contract construction by American firms in more than 100 countries abroad.

The Associated General Contractors of America (AGC) represents more than 32,000 firms including 8,500 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 employees. These member contractors perform more than 80% of America's contract construction of commercial building, highways, industrial and municipal-utility facilities.

AGC supports amendments to S644 which would amend the Federal National Mortgage Association (FNMA) Charter Act to allow FNMA as a portion of its mortgage activities to:

1) permit FNMA to purchase nonresidential mortgages serving the needs of residents of subdivisions, neighborhoods, housing projects, or other residential areas up to 10% of each year's secondary mortgage market activity by the corporation and;

2) to remove loan-to-value restrictions on FNMA multifamily mortgages.

AGC believes these amendments would strengthen FNMA by giving it access to higher yielding, shorter term assets thus making FNMA less vulnerable to shifts in interest rates. The removal of the loan-to-value restriction would help FNMA to meet the demand for longer term commitments to purchase multifamily conventional loans upon completion of construction, and to issue long term take out commitments supporting the issuance of housing finance bonds by state and local agencies. By improving the mechanism for financing multifamily and nonresidential mortgages, FNMA will enhance its traditional support for housing. Easier financing increases chances for development of quality neighborhoods with integrated living and work space.

The improvements in the secondary mortgage market will help to increase funding for housing and neighborhood development activities thus helping to ease present chronic unemployment in the construction industry. At present, 1.2 million construction workers are unemployed This represents almost 25% of the work force of the nation's largest industry.

AGC further supports these amendments as part of the larger effort to improve the efficiency of and commitment of public investment in America's infrastructure.

A recent survey by AGC identified $112 billion multifamily and low income housing needs projected over the next 10 years. Without improvements in the financing system these needs will not be met.

Statement of the Coordinating Council on Manufactured Housing Finance and the National Manufactured Housing Finance Association

Mr. Chairman and members of the Committee, the National Manufactured Housing Finance Association ("NMHFA"), and the Coordinating Council on Manufactured Housing Finance ("Coordinating Council") appreciate this opportunity to present their views concerning the proposed charter authority amendment to permit the Federal Home Loan Mortgage Corporation ("FHLMC") to purchase manufactured home personal property loans and to guarantee or issue securities backed by such loans.

The NMHFA is a national association composed primarily of lenders who finance the purchase of manufactured homes both through the use of the federal housing credit programs, including those of the Federal Housing Administration ("FHA"), the Government National Mortgage Association ("GNMA") and the Veterans Administration ("VA"), and through conventional financing. The members of the Association finance a substantial majority of the FHA-insured and VA-guaranteed manufactured home loans for which GNMA provides secondary market financing through its guaranty of manufactured home mortgage-backed securities. The membership of the Association also includes insurance companies and investment banking firms which do business in the manufactured home area.

The Coordinating Council is comprised of three major manufactured housing industry trade associations. They are: the Manufactured Housing Institute, the national association representing approximately 80 corporations which manufacture homes and some 300 supplier firms which furnish components, services, and financing to the industry; the Western Manufactured Housing Institute, representing manufacturers and suppliers in the western United States; and the National Manufactured Housing Federation, representing 41 state and regional associations of manufacturers, suppliers, retailers, and park operators.

Manufactured homes make up a significant share of the nation's single-family housing and this share continues to grow. In 1982, manufactured housing accounted for approximately 36.6% of all new single-family homes sold, and for approximately 26.5% of single-family structures started.

Currently the only organized secondary market for manufactured home personal property credit sales instruments is the GNMA Mortgage-Backed Securities ("MBS") program. The GNMA MBS program is a tremendously successful secondary market program. Since its inception, it has enjoyed enthusiastic lender and investor participation, and has provided much-needed investment capital for the financing of manufactured homes. GNMA's programs, however, are limited to federally insured or guaranteed loans only.

No organized secondary market exists at this time which can accommodate conventional manufactured home personal property loans. Although authority was granted to the Federal National

Mortgage Association ("FNMA") in 1980 to purchase such loans, FNMA has not yet established a manufactured home personal property loan program. Therefore a void exists in the secondary market as to these loans, which FHLMC could fill if granted the authority.

The Committee and Congress have recognized the importance of secondary market access for manufactured home loans by enacting Title VIII of the Garn-St Germain Act, the "Alternative Mortgage Transaction Parity Act of 1982," and including residential manufactured home loans as a part of that legislation.

A major goal of our national housing policy has been to encourage the growth and involvement of the private market in directing investment funds to meet the housing credit needs of prospective homebuyers, particularly the first-time homebuyer. Because manufactured housing is typically more affordable housing than that which is site-built, it historically has provided many first-time homebuyers, along with many other segments of the population, with the opportunity to own their own homes. In fact, the Report of the President's Commission on Housing (May 1982) commended manufactured housing as a "significant source of affordable housing for American families, particularly first-time homebuyers, the elderly, and low- and moderate-income families" (page 85). If granted the authority, FHLMC could play a crucial role in providing greater access to this important housing market.

The authority for the establishment of such a program takes on added significance in view of the changing emphasis of the federal housing credit programs to target more credit-needy areas, and to increase the housing industry's reliance on conventional financing and the private market. In its Report last May, the Commission stressed the important role of FHLMC and FNMA in the development of markets for conventional loans. In addition, the Commission specifically recommended that "more broadly based access to the credit markets should be developed for the financing of manufactured housing held as personal property" (page 86).

In sum, the National Manufactured Housing Finance Association and the Coordinating Council on Manufactured Housing Finance strongly support legislation which would amend the charter authority of FHLMC to permit FHLMC to purchase manufactured home personal property loans. We expressly urge the Committee to make the FHLMC charter authority amendment a part of this year's housing legislation so that FHLMC may proceed to develop its program.

We appreciate the opportunity to present the views of the NMHFA and the Coordinating Council on this matter, and we are grateful for the interest you have taken in this important legislation.

6863B-246

THE IRVINE COMPANY
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Newport Beach, California 92660-0015
(714) 720-2000

May 13, 1983

Chairman John Tower
Subcommittee on Housing and Urban Affairs
Dirksen Senate Office Building
Room SD-534
United States Senate
Washington, DC 20510

Dear Chairman Tower:

The Irvine Company strongly supports an increase in the mortgage purchase limit for FNMA and FHLMC. The current limit of $108,300 does not provide adequate access to the secondary market resources of FNMA and FHLMC for the moderate priced homebuyer in high cost areas such as Orange County, California. The problem is not singular to California but effects the moderate and middle income homebuyer in high cost areas in almost every state.

FNMA and FHLMC were Congressionally chartered to provide affordable mortgage credit for moderate and middle income homebuyers throughout this country. Today the $108,300 ceiling serves to discriminate against many of the people meant to be served by these institutions who are living in these high cost areas.

The Garn-St. Germain Depository Institutions Act of 1982 allowed federally regulated financial institutions greater flexibility in investing their assets. The effect is to reduce the portion of their assets invested in housing. A viable secondary market assures liquidity to investors in mortgages. Access to this principal source of mortgage funds because of the 1982 Act is more important now than ever before.

Our experience is that few institutions offer fixed rate financing for loans over $108,300. Over the past two years we have found that only State Savings and Loan Association of Stockton, California has been willing to make commitments for such nonconforming loans. The cost of this financing, which, of course, is paid by our homebuyers, has been substantially higher than that of conforming loans.

A major concern effecting legislative action at this time is opposition to increasing the purchase limit for FNMA and FHLMC by the private secondary conduits, particularly Residential Finance Corporation, a subsidiary of Banco Mortgage and General Electric Credit Corporation. They are attempting to develop a private secondary market for mortgages over $108,300. It is their contention that they will not be successful unless FNMA and FHLMC are excluded entirely. Private market interest rates are projected to be 40 to 50 basis points above FNMA and FHLMC because they lack the inferred government guarantee.

The Irvine Company supports the development of private secondary market conduits while at the same time supporting access to the market above $108,300 for FNMA and FHLMC for a variety of reasons.

Only FNMA and FHLMC have a Congressionally mandated commitment to housing. Residential Finance Corporation and General Electric Credit Corporation are making a commitment as long as the market is profitable, and have testified that they are prepared to make a substantial commitment to the nonconforming loan market. While we welcome their future participation, we doubt that their commitment will be sufficient to meet the demonstrated market need over the next several years.

The market about $108,300 is so large that private institutions could not meet the demand in the foreseeable future. The Mortgage Bankers Association Economic Department compiled figures this month which indicate that mortgage loan originations in 1983 are estimated to be $145 billion, with $45 billion above $100,000. FHLMC estimates that originations will be approximately $160 billion with $42 billion between $108,300 and $150,000 and $22 billion above $150,000. This year Residential Finance Corporation, which has purchased $400 to $500 million in mortgages in the spot market so far, estimates their purchases in the coming year to be $4 to $5 billion. General Electric Credit Corporation has not yet purchased a single mortgage. If FNMA and FHLMC were permitted to purchase in this market using 10% of their resources as one proposal would allow, and assuming an optimistic combined total business of $60 billion, they would only purchase $6 billion. This still leaves an ample market share for private conduits. It should be noted that there are already private conduits active in the market below $108,300. To date, 10% of Residential Finance Corporation's purchases are below $108,300.

And finally, FNMA's and FHLMC's presence in the marketplace will help establish a bench mark for pricing private issuances and ensure competitive pricing. This is more important in the early stages of the market development when there are few companies with limited resources and a large market to be served.

The Irvine Company strongly supports the development of a viable secondary marketplace. It would be ideal if this market could be totally private, however, we do not feel the private secondary market conduits have sufficient capacity at this time to meet the need. We believe that FNMA and FHLMC participation in the nonconforming loan market at this time would help to assure an orderly and liquid secondary market at no direct cost to the Federal government. Therefore, we urge an increase in the mortgage purchase limit for FNMA and FHLMC.

Sincerely yours,

Warren D. Fix
Senior Vice President, Finance